CONSULTATION/INLAND REVENUE DRAFT LONG-TERM INSIGHTS BRIEFING

Stable bases and flexible rates: New Zealand's tax system

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Inland Revenue
Te Tari Taake

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Message from Chief Executive

I am delighted to present Inland Revenue's draft 2025 Long-term Insights Briefing for consultation, Stable bases and flexible rates: New Zealand's tax system.

Inland Revenue, like other government departments, has a duty of stewardship to look ahead and provide advice on future challenges and opportunities. As part of carrying out this duty, Inland Revenue is required under the Public Service Act 2020 to produce a Long-term Insights Briefing once every three years.

Long-term Insights Briefings provide departments with an opportunity to look beyond their day-to-day activities, taking a future focus to explore issues that may affect New Zealand and New Zealanders. The briefings provide information on long-term trends, risks and opportunities, as well as possible policy options for responding to these matters. They do not seek to identify immediate actions, and they do not represent Government policy. Instead, they discuss the pros and cons of various options to promote debate.

Inland Revenue's 2025 Long-term Insights Briefing looks at how the tax system may need to respond to future challenges. In particular, New Zealand's population is ageing and this will create fiscal pressures in the future. This briefing considers how to make sure the tax system can adapt to changing revenue needs over time and explores what broad structure of the tax system may be suitable for the future.

A fit for purpose tax system underpins the wellbeing of all New Zealanders. I encourage you to read our draft briefing and take the opportunity to submit your comments.

Peter Mersi

Commissioner of Inland Revenue Te Tari Taake

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Executive summary

This document is the draft of Inland Revenue's second Long-term Insights Briefing (LTIB). Inland Revenue is seeking feedback on this draft by 1 September.

LTIBs are a requirement of the Public Service Act 2020. They are required to set out medium- and long-term trends, risks and opportunities as they affect the interests of Aotearoa New Zealand. LTIBs discuss the pros and cons of various options to respond to these trends and consequently promote public debate.

The key motivation for this LTIB is that New Zealand, like other developed countries, faces long-term fiscal pressures. In particular, the ageing of the population will place upward pressure on superannuation and health care expenditure over time. Future governments have choices to respond to these pressures by either making changes to expenditure programmes or increasing the amount of tax that is raised relative to the size of the economy. However, the fiscal system will be more resilient if the tax system can easily adapt to changing revenue needs over time. This document refers to this as a flexible tax system, that is, a tax system with the ability to increase the level of revenue raised – should expenditure increase – without undue equity or efficiency cost. While having the flexibility to meet the revenue needs of the day is important, it is also important for the tax structure to be reasonably stable to support investment certainty.

Given these issues, the key question explored in this LTIB is how to design a durable tax system in the face of long-term fiscal pressures. Inland Revenue proposes that a durable tax system is one with a stable core structure while providing the flexibility to adapt to changing revenue needs, or the different distributional objectives of different governments, over time. Given this key question, the focus in this LTIB is on taxes aimed at raising revenue.

This LTIB is in two parts. Part 1 (Chapters 1 to 3) looks at the principles and framework used to assess different options for the tax system for the future. Part 2 (Chapters 4 to 7) then looks at possible modifications, or improvements, to New Zealand's tax system. It looks at the income tax, consumption tax, and whether it would make sense to add any alternative bases to that mix. A brief summary of this document follows.

Part 1: Principles and systems

Chapter 1: Looks at the principles used to assess options for different tax system designs. In general, Inland Revenue considers that the framework articulated by the McLeod Review, that the objective of the tax system is to raise the amount of revenue that the government requires in a way that imposes as little cost on taxpayers as possible (that is, it is as efficient as possible) while promoting fairness, provides a helpful guide to tax policy. In designing the tax system, governments face trade-offs between efficiency and equity. Different governments will make different trade-offs over time. Given this, for the tax system to be durable it will need to have the flexibility to meet different governments' distributional goals – and allow different trade-offs to be made – over time.

Chapter 2: Seeks to compare different tax bases using a common framework of comparison. It looks at the extent to which different tax bases tax the fundamental economic factors of labour

income, capital income and existing wealth. This framework highlights the overlaps and differences between different tax bases and allows us to think about how tax bases can be sensibly combined into a tax system. In short, a labour income tax, general income tax, general income tax with a risk-free rate of return deduction, dual income tax and a consumption tax all tax labour income or do something equivalent. However, these taxes differ in how they tax capital income. Only the general income tax taxes the risk-free return (normal return or return from delaying consumption) to capital income at the same rate as labour income, a dual income tax taxes the normal return at a lower rate than labour income. The other taxes do not tax the normal return to capital. So, these tax bases can be distinguished in terms of their effect on taxing the normal return to capital (or income from savings).

Chapter 3: Looks at current literature assessing the arguments on the desirability of taxing labour versus capital income and whether these forms of income should be taxed at the same or different rates. Some years ago, there was a conventional wisdom amongst economists that there was a solid "in-principle" case against taxing the normal return to capital. More recent work has cast doubt on that conclusion. It seems to us that the economic literature here is complex, inconclusive and unlikely to be resolved in the next few years. However, Inland Revenue considers that the balance of opinion is towards taxing the normal return to capital of domestic residents but potentially at lower rates than labour income and excess returns to savings. There are, however, economic costs from taxing the return to capital of non-residents too highly because much of the tax on inbound investment will be borne by domestic factors such as through lower wages in New Zealand.

Part 1 concludes that having the main bases of an income tax and a consumption tax can achieve a desirable tax mix for New Zealand (based on equity and efficiency grounds), and provide for flexibility for different governments to make different trade-offs between equity and efficiency goals over time. In terms of the structure of the income tax, either a general income tax or a dual income tax could achieve a desirable mix, so an important question is which of these income tax bases would provide more flexibility (that is, the ability to raise higher revenue in a way that is fair and least cost) to meet changing revenue needs over time.

Part 2: New Zealand's tax system

Chapter 4: Looks at New Zealand's income tax with a particular focus on possible modifications that may make it more flexible to changing revenue needs. Chapter 4 looks at two key issues with New Zealand's current income tax that may limit its flexibility to adjust to changing revenue needs. The first is the comprehensiveness of the income tax base. Unlike most OECD countries, New Zealand does not have a general approach to taxing capital gains. This can lead to opportunities to earn income in untaxed or lower taxed forms. However, there are pros and cons of taxing more capital gains. While a general capital gains tax would provide for a more neutral approach to taxing income and more neutrality in savings choices, realisation-based capital gains taxes give rise to economic costs from the lock-in effect and compliance costs, and provide a penalty on risk-taking because gains and losses are not treated symmetrically. The second issue explored in this chapter is the integration of personal and company taxation. There are good reasons to have a company tax rate lower than top personal rates; however, this creates opportunities to shelter income in companies and hence receive a lower tax rate. Chapter 4 also looks at potential approaches to improve the shareholder–company boundary in the current

system and whether a dual income tax provides any benefits for shareholder–company integration.

Chapter 5: Looks at approaches to enhance the flexibility of New Zealand's consumption tax to adjust to changing revenue needs while meeting distributional goals. New Zealand's broad-based goods and services tax (GST) provides a good base from which to raise revenue. However, because it is not a progressive tax, future governments may discount using GST to raise additional revenue due to the impact on low-income families. Alternative ways to design consumption taxes that allow for progressive rates have been proposed in the literature, however, these alternatives have some significant downsides compared to a value-added tax. Therefore, Inland Revenue considers that it makes sense for New Zealand to continue with a broad-based, value-added tax such as GST. Chapter 5 explores options to use GST to increase revenue, while mitigating the effect on lower-income households. It looks at the effectiveness of low-income transfers versus exempting certain goods from GST to mitigate the impacts of a GST increase on low-income households. The literature finds that low-income transfers can be more cost effectively targeted at low-income households than exemptions to the GST base. We undertake a modelling experiment that demonstrates that a targeted, income-tested GST offset could insulate low-income families from a GST increase at modest fiscal cost.

Chapter 6: Looks at the arguments for adding alternative tax bases to a tax structure of two main bases of an income tax and a value-added consumption tax. It draws on the framework in Chapter 2 to assess the effect of adding new bases and considers the fairness and efficiency effects of alternative bases. The bases considered are payroll taxes, wealth taxes, inheritance taxes, and land and property taxes. Chapter 6 also briefly considers social security contributions, which are common in OECD countries and often used to fund particular expenditures, and stamp duties. The chapter concludes that all these alternative bases would overlap to some extent with the existing bases of income tax, GST and local government rates. Further, if it makes sense to add a base at higher revenue levels it likely also makes sense to add it at current revenue levels. This underscores the focus of this LTIB on a durable tax system being one with a stable core structure with the flexibility to adjust rates to meet changing revenue needs.

Chapter 7: Draws together the above analysis to provide insights on different approaches to raising revenue to meet long-term fiscal pressures. In summary, it concludes that flexibility to adjust rates on the main bases will be an important element of fiscal resilience over the medium to long term.

Some questions to assist responses follow.

Questions for submitters

Q1. What do you see as the key attributes of a durable and stable tax system in the face of long-term fiscal pressures?

Q2. Do you consider that New Zealand should continue with the two main bases of an income tax and a consumption tax going forward?

Q3. To what extent should New Zealand rely on increasing rates on its main tax bases versus adding new tax bases to address long-term fiscal challenges?

Q4. Do you consider that the tax system should be designed with the flexibility to adapt to different governments' distributional concerns over time?

Q5. What do you see as the main mechanisms that could be used to increase the flexibility of the current income tax to changing revenue needs?

Q6. What mechanisms do you see as most effective in improving company–shareholder integration under the current system?

Q7. What do you see as the pros and cons of a general income tax versus a dual income tax for New Zealand?

Q8. What do you see as the pros and cons of a low-income GST offset scheme to address distributional concerns should the GST rate be increased?

Q9. Do you see alternative tax bases as desirable to add to New Zealand's tax mix at current or higher revenue needs?

Making a submission

Email your submission to policy.webmaster@ird.govt.nz with Stable bases and flexible rates: New Zealand's tax system in the subject line, or

- by post to:

  Stable bases and flexible rates: New Zealand's tax system
  C/- Deputy Commissioner, Policy
  Inland Revenue Department
  PO Box 2198
  Wellington 6140

Privacy of submissions

Submissions may be requested under the Official Information Act 1982. Please clearly indicate in your submission if you consider that any information should be withheld on the grounds of privacy, or for any other reason. Contact information such as an address, email, and phone number for submissions from individuals will be withheld. Whether any information is withheld will be determined using the Official Information Act 1982.

Overview and motivation

Purpose of Long-term Insights Briefings

Long-term Insights Briefings (LTIBs) are a requirement of the Public Service Act 2020. They are independent of Ministers and do not represent Government policy. LTIBs present medium- and long-term trends, risks and opportunities that affect the interests of Aotearoa New Zealand. They provide analysis and explore options for addressing these risks, giving the public service the opportunity to think innovatively about issues over a longer time frame and provide an opportunity for public discussion of these issues. LTIBs discuss the pros and cons of various options and promote debate on options rather than recommending immediate action or taking a policy position.

This document is the draft of Inland Revenue's second LTIB. It looks at issues affecting the tax system over the coming decades and considers options for what broad structure of the tax system may be suitable for the future.

As required by the Public Service Act, Inland Revenue is now consulting on this draft document. Following consultation, the document will be finalised and presented to the House of Representatives in late 2025.

Issues motivating this LTIB

In Aotearoa New Zealand around a third of gross domestic product (GDP) is raised in tax. The tax system is integral to New Zealander's collective wellbeing because it provides the main source of revenue for public services such as the health and education system. How the tax system is structured has significant economic affect and reflects weighing considerations about what is "fair" between different cohorts of society. Tax policy should not be static but needs to respond to changes in society and the economy over time.

To scope the topic of this LTIB Inland Revenue undertook an Environmental Scan, which was published with the topic consultation document (Inland Revenue, 2024). The Environmental Scan identified two key motivations for this LTIB.

Fiscal pressures from ageing population

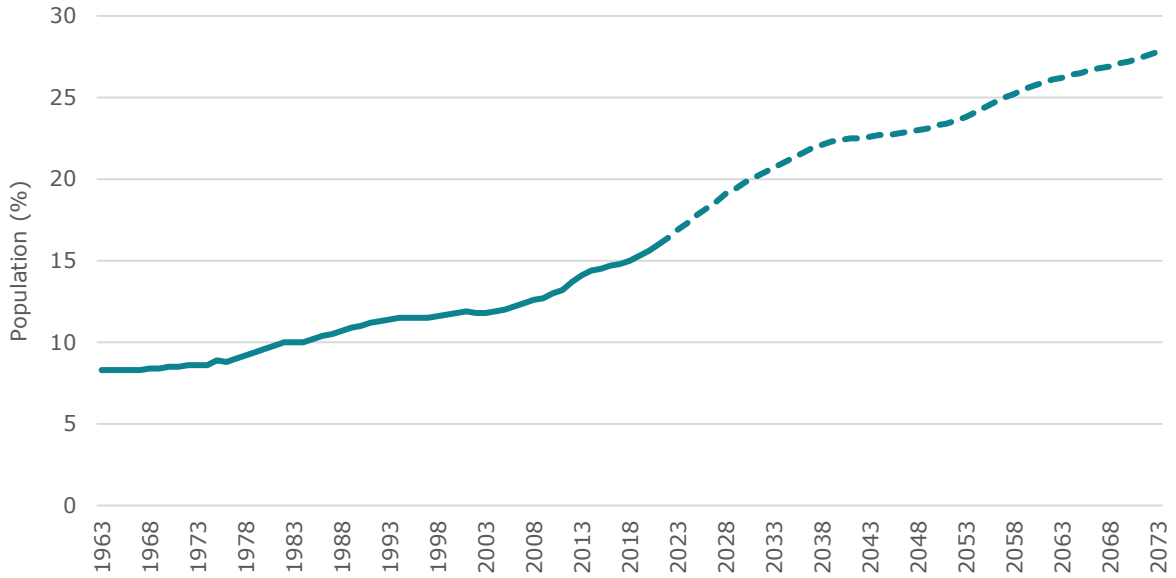
The first motivation for this LTIB is that New Zealand's population is ageing. Figure 1 shows that it is expected that a quarter of the population will be aged 65 or over by the late 2050s.

The ageing of the population, and other factors, will create fiscal pressures over the coming decades. In particular, the Treasury's 2021 Statement on the Long-term Fiscal Position (LTFS) (*He Tirohanga Mokopuna*, 2021*)* showed that the net of tax cost of New Zealand Superannuation will grow from 4.2% of GDP in 2021 to 6.4% of GDP by 2061 if current settings remain in place.[1] The LTFS also projected health expenditure to increase from 6.9% of GDP in 2021 to 10.6% of GDP by 2061 under the historical trend scenario. There are also fiscal pressures from environmental

[1] This is reduced to 5.9% of GDP if withdrawals from the New Zealand Superannuation Fund are included.

factors such as climate change and biodiversity loss. Overall, the LTFS projected an operating balance deficit of 13.3% of GDP by 2061 if current revenue and expenditure settings are maintained and the Government makes no response to fiscal pressures (LTFS, Table 3). The Treasury's next LTFS is due in late 2025.

Figure 1: Proportion of total population over 65, 1963–2073



Source: Statistics New Zealand (2022)

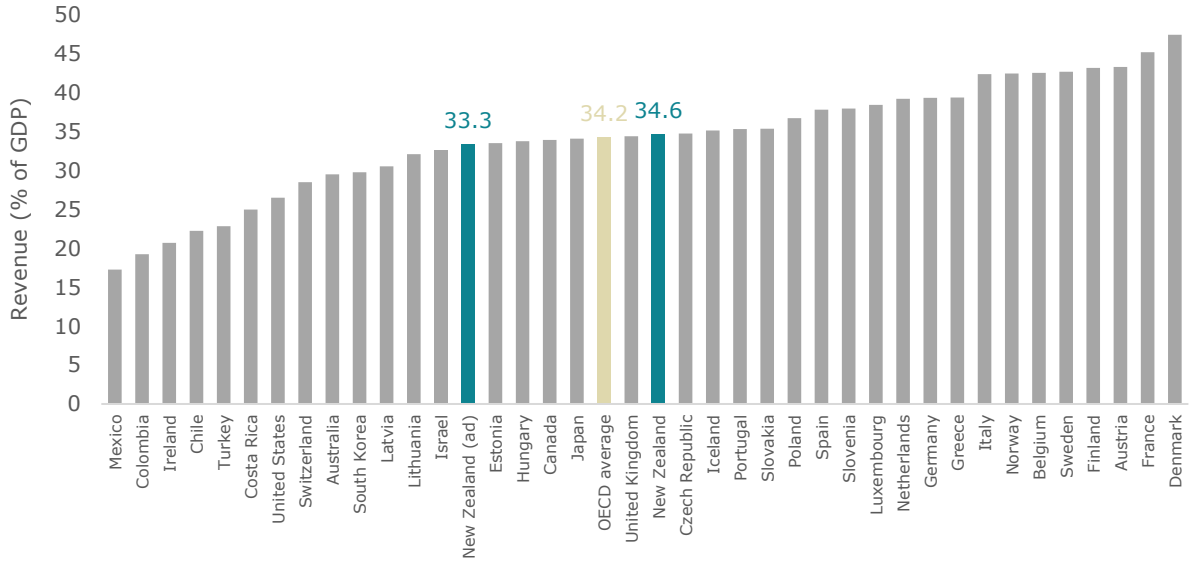
While future governments have the choice to manage future fiscal pressures through expenditure control, greater use of private funding or increases in tax-to-GDP, there will be greater fiscal resilience (the ability to fund current government expenditure from current revenue) if the tax system can easily adapt to changing revenue needs over time. This paper refers to the *flexibility* of the tax system as the ability of tax settings to adapt to varying revenue requirements over time in a way that is fair and does not impose undue efficiency cost. A flexible tax system would also be able to adapt to changing government distributional goals over time. Therefore, a flexible system would be one that raises sufficient revenue as fairly and efficiently as possible through time and across governments with different distributional goals.

From a global perspective, expenditure pressure from ageing populations is ubiquitous in developed countries. OECD projections put New Zealand close to the median OECD country in terms of forecast fiscal pressures (Guillemette & Turner, 2021).

Looking at the level of tax revenue New Zealand raises compared to other OECD countries, Figure 2 shows that New Zealand's tax-to-GDP ratio is around the OECD average, with 16 countries having a tax-to-GDP ratio more than 2 percentage points above that of New Zealand (on an adjusted basis).[2]

[2] In Figure 2, New Zealand (ad) adjusts for the fact that New Zealand charges GST on public services whereas other countries do not. The methodology for the adjustment is discussed in the Environmental Scan footnote 14. Figures 2 and 3 present revenue as a percent of general government revenue, which for New Zealand includes local government rates.

Figure 2: General government tax revenue as a percent of GDP, 2021



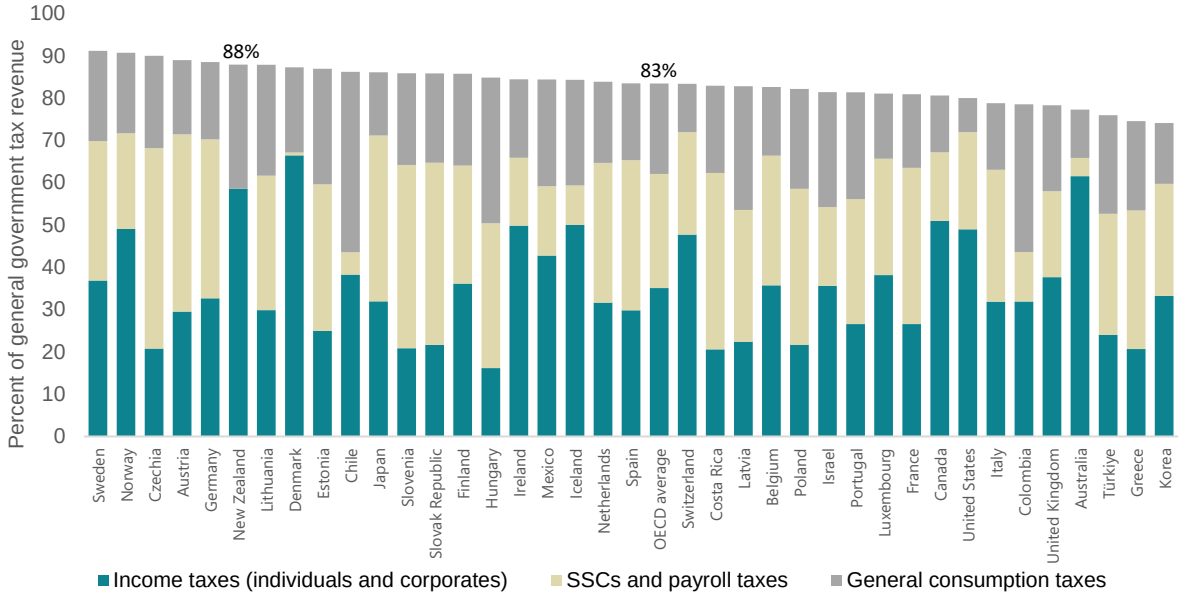
Source: OECD (2024)

Tax structure

While flexibility to adjust to changing revenue needs supports fiscal resilience, stability in the core structure of the tax system is also important in keeping the economic costs of taxation low and to support fairness. This is because certainty as to the tax structure will support investment decisions and allow people to plan for the future. It will also minimise disruption to existing expectations.

As shown in Figure 3, New Zealand's tax system relies on the main bases of income and consumption tax which together comprise 88% of general government revenue (this includes local government rates in total revenue).

Figure 3: Sources of revenue as a percent of general government tax revenue, 2021



Source: OECD (2024)

However, while all OECD countries have an income tax that taxes labour and capital income, and a general consumption tax, New Zealand is unusual in not having a significant tax base that only applies to labour income, such as a social security contribution tax (SSC). Further, some OECD countries operate schedular tax systems that tax labour income at a higher rate than capital income, or otherwise have lower rates on capital income, thereby providing relatively low taxation of savings. Indeed, there is considerable variation in tax structures across OECD countries. It is useful to explore these other approaches to tax system design, the motivation for alternative designs, and what can be learnt from these approaches.

Considering this, this LTIB also explores what core structure of the tax system will be suitable for the future. Important principles in the design of the tax structure are equity and efficiency (that is, keeping the costs of taxation low). These principles have underpinned the broad-based, low-rate framework that has guided policy development in New Zealand for the last 40 years.

Key question

Given these two motivations, the key question explored in this LTIB is how to design a durable tax system in the face of long-term fiscal pressures. Inland Revenue proposes that a durable tax system is a tax system with a stable core structure that is likely to be acceptable to different governments over time while providing the flexibility to adapt to changing revenue needs, or different distributional objectives of different governments, over time.

The focus in this LTIB is on taxes that are levied with the central purpose of raising revenue. We do not focus on corrective taxes, that is taxes such as a carbon tax that are levied to correct behaviour so that individuals and firms take account of the full social cost of their actions. While corrective taxes are important, revenue taxes are a large topic in themselves, and our topic motivations more naturally lead to a consideration of the best system for raising revenue. Similarly, this paper does not systematically examine the welfare system but rather focuses on aspects of integration of the tax and transfer system most relevant to our topic. Although tax and welfare systems are closely linked, many aspects of the welfare system do not depend on tax design, so a full examination of the welfare system is beyond the scope of this paper.

In this LTIB, we mainly focus on the taxation of domestic residents rather than inbound investment, which was the focus of our last LTIB.

Flexible tax system with stable core structure

As noted, a key motivator for this LTIB is fiscal pressures from an ageing population. The main idea is that the tax system of the future needs to be one with a stable core structure but with the flexibility to adapt to changing revenue needs, or government distributional goals, over time.

Flexibility relates to the core purpose of the tax system – to raise adequate revenue to fund government expenditure needs. As discussed in Chapter 1, it remains important that the core tax structure be designed in a way that is fair and raises revenue at low cost.

Under a flexible tax system, the level of revenue would be able to be easily raised, if expenditure increased, in a way that did not substantially undermine the government's equity and efficiency goals. A flexible fiscal system would be one in which gradual adjustments could be made to keep

the budget in balance without the need for large-scale reforms or excessive volatility in the level of revenue raised.

In Inland Revenue's view, a good strategy to create a flexible tax system with a stable core structure would be to design the mix of tax bases to comprehensively tax the factors sought to be taxed (based on equity and efficiency) and to have the capacity to alter rates (or thresholds) on main bases to meet differing revenue needs or distributional goals over time. A flexible tax system does not require that every base have rate flexibility; flexibility is likely not important for smaller bases or for taxes aimed at changing behaviour, such as environmental taxes. However, the fiscal system will have greater resilience if rates can be changed on the main bases without undue equity or efficiency cost. We welcome submitters' views on this strategy to adjust to long-term fiscal pressures.

In Inland Revenue's view, the ability to adjust rates on main bases will be a more flexible adjustment mechanism than adding new tax bases when revenue needs change. This is because adding new bases takes time, imposes significant transition and administration costs and provides for a significant amount of new revenue at one point of time rather than providing a gradual transition. If a new base is considered desirable, for example if it taxes an otherwise untaxed factor or has desirable distributional properties, it likely makes sense to add that base to the current structure and reduce revenue from other bases (although there may be a stronger case for some smaller bases at higher revenue levels). Therefore, Inland Revenue considers a better long-term strategy is to ensure the mix of tax bases comprehensively covers the factors that are sought to be taxed, with the ability to adjust rates on those bases.

Given this, the key question explored in Part 1 is the pros and cons of different main bases for a stable core structure. This question is relevant at current or higher revenue needs. To answer this question, Chapter 1 considers the principles of equity and efficiency, and trade-offs between them, as the analytical framework for tax structure design. Chapter 2 considers what underlying economic factors are taxed under different main bases, in particular understanding overlaps and differences between bases. Chapter 3 considers whether labour and capital income should be taxed at the same or different rates, and the balance of taxation of these factors achieved in different tax system designs.

Part 1 concludes that having the main bases of an income tax and a consumption tax can achieve a desirable tax mix for New Zealand going forward, and provide for flexibility for different governments to make different trade-offs between equity and efficiency goals over time. Part 2 therefore proceeds on the basis that New Zealand continues with the main bases of an income tax and a consumption tax. Part 2 focuses first on how to make these main bases more flexible to changing revenue needs and second on the pros and cons of adding alternative bases to this mix.

It could be thought that broadening the base of New Zealand's main bases is a sufficient strategy to address long-term fiscal pressures. Base broadening should, however, be consistent with the underlying base. It only makes sense to broaden the income or consumption base to capture untaxed income or consumption and it is important to make sure that tax bases allow deductions for valid expenses. Further, if there is a case to broaden bases on fairness or efficiency grounds, this likely exists at current revenue levels. As discussed in Part 2, New Zealand's consumption and income tax bases are already broad compared to what is sought to be taxed, and potential base-broadening opportunities may not be sufficient in themselves to address long-term fiscal

pressures. Therefore, while broadening the tax base can support revenue, equity and efficiency goals, Inland Revenue also considers that flexibility to adjust rates needs to be part of the strategy of adjusting to long-term fiscal pressures.

For this reason, Chapters 4 and 5 focus on how to increase the flexibility of New Zealand's current main bases to rate changes – that is, how to design these bases in ways that rates can be increased without undue equity and efficiency cost. We discuss current constraints on rate flexibility for the income and consumption tax and mechanisms that may reduce these constraints.

Chapter 4 focuses on two issues that may reduce the flexibility of the income tax base: comprehensiveness of the income tax base and the integration of company and shareholder taxation. These features of the tax system could constrain the ability of future governments to increase the level of revenue raised in a way that is progressive because they provide opportunities to earn income in non-taxed or lower-taxed ways thereby reducing the equity and efficiency of an income tax increase. Chapter 4 considers the pros and cons of more consistently taxing income and alternative ways to manage boundaries between the personal and company regimes including considering whether a dual income tax manages this boundary better.

Regarding GST, the broad base of New Zealand's GST means changes in the rate are effective in changing the revenue gained. However, GST applies at a flat rate to expenditure so future governments may discount using GST to increase revenue levels due to distributional concerns arising from the effect on low-income individuals. Chapter 5 investigates approaches to make consumption taxes more distributionally responsive, including approaches to mitigating the effect on low-income households from increases in consumption tax rates. This includes looking at the feasibility of low-income offsets as part of a GST increase.

Finally, Chapter 6 considers the arguments for adding new bases to the current tax mix. New bases may be desirable, even at current revenue levels, if they provide an efficient form of taxation or have desirable distributional properties. Further, if the flexibility of New Zealand's main bases to changing revenue needs cannot be improved, adding new bases may be the best strategy to adapt to increased revenue needs if required.

Chapter 7 concludes and draws out key insights on how the tax system can adapt to long-term fiscal pressures.

LTIB's approach

Motivated by these issues, this document contains the following chapters:

Part 1: Principles and systems

- Principles: Chapter 1 discusses the principles we will use to examine the desirability of alternative tax structures; in particular, the concepts of fairness and economic efficiency.
- Overlapping tax bases: Chapter 2 draws on the idea that different legal tax bases can be taxing the same underlying factors or be doing something equivalent. It investigates the overlaps and differences in what is taxed under different tax bases.
- Taxes on labour and capital income: Chapter 3 discusses whether labour and capital income should be taxed at the same or different rates. It discusses how different systems of taxation balance the taxation of labour and capital income.

Part 2: New Zealand's tax system

- Income tax: Chapter 4 investigates potential options to improve the income tax base with a particular focus on how to make the income tax more responsive to changing revenue needs. This includes considering whether a dual income tax is a more flexible system than a general income tax.
- Consumption tax: Chapter 5 considers how to make the consumption tax more distributionally responsive if consumption taxes were used to meet higher future revenue needs. This includes looking at options for a low-income offset in the case of an increase in the GST rate.
- Alternative bases: Chapter 6 looks at what bases, if any, would make sense to add to the main tax bases under New Zealand's current system.
- Increasing flexibility – conclusions: Chapter 7 draws the document together and sets out key insights and lessons for addressing long-term fiscal pressures.

Part 1: Principles and systems

Part 1: Introduction

As discussed, the key idea we explore in this LTIB is how to design a durable tax system in the face of long-term fiscal pressures. A durable tax system is a tax system with a stable core structure that is likely to be acceptable to any future government while providing sufficient flexibility to meet the differing revenue and distributional objectives of those future governments.

Many reviews of tax policy have argued that the design of the tax system should be based on a clear and consistent set of principles. This is important if the tax system is to be generally accepted as being fair. Having a clear set of principles and vision for the tax system will also help ensure that the core structure of the tax system is as stable and durable as possible.

The goal of Part 1 of this LTIB is three-fold. First, we discuss the principles we will use to assess different tax system designs, or different options to meet future revenue needs. Articulating these principles highlights the trade-offs that are involved in various choices about tax system design.

In Inland Revenue's view, a simple framework based on revenue sufficiency, equity and efficiency is generally adequate to highlight the trade-offs in tax system design. Equity and efficiency are broad and complex concepts that can take account of most aspects of wellbeing – although there will be some cases when additional insights can be gained from alternative frameworks such as He Ara Waiora, which highlights the te ao Māori perspective.

Second, our goal is to understand what is fundamentally taxed under different tax bases and different systems of taxation. We provide a common framework to assess the similarities and differences between tax bases to compare the effects of taxes that apply to different legal bases. A key insight is that different legal tax bases can often have substantial overlap but also some important differences.

Third, we also provide a review of literature assessing the pros and cons of taxing labour versus capital income to consider whether labour income and different forms of capital income should be taxed at the same or different rates. We also consider practical issues with taxing capital income that can create inherent non-neutralities for income taxes.

Together, these chapters allow us to draw out insights on the pros and cons of different tax bases and implications for the tax mix. Chapter 3 concludes that an income tax and a consumption tax provide suitable main bases for New Zealand going forward. Despite the inherent non-neutralities of an income tax, retaining two main bases provides two broad bases from which to raise revenue and a balanced approach that allows governments to retain flexibility to adjust the tax mix to changing priorities over time.

Chapter 1 – Principles

Overview

Chapter 1 looks at the principles for tax policy design.

Having a clearly articulated framework and principles for tax policy design will help ensure policy consistency over time. This will support the stability of the tax system and help to ensure that the tax system is generally accepted as fair and will minimise uncertainty.

The McLeod Review suggested that the objective of the tax system should be to raise the amount of revenue that the government requires in a way that imposes as little cost on taxpayers as possible (that is, it is as efficient as possible) while promoting fairness. We think that this provides a good basic framework to assess tax policy design and will be adequate in most cases to highlight the inherent trade-offs involved in tax policy.

However, at times, additional insights into aspects of wellbeing that are important to people can be gained from alternative frameworks, such as Māori perspectives gained through He Ara Waiora.

This chapter discusses in depth the concepts of fairness and efficiency.

Different aspects of fairness include that tax is levied in a way that appropriately reflects ability to pay (vertical equity), those in similar positions are treated similarly (horizontal equity), fairness of process (including the means articulated in He Ara Waiora), and transitional fairness.

Taxes impose costs in excess of the revenue raised (efficiency costs). These include distortionary costs (costs associated with people making different decisions than they otherwise would have due to taxes), administrative costs and compliance costs. In general, broad tax bases will keep the efficiency costs of raising taxes lower than narrow tax bases and will be consistent with horizontal equity.

Both fairness and efficiency will be supported by the rules of thumb of neutrality and simplicity. These principles will also be supported by having open and healthy debates on potential reforms and adequate consultation on potential policy changes.

A key decision for governments is how progressive the tax system should be. This involves trade-offs between equity and efficiency. When thinking about progressivity, it is useful to think about the overall public finance mix – that is, the joint impact of the tax and transfer system as well as public spending.

A durable tax system will need to be able to accommodate different governments' views on how to balance equity and efficiency concerns over time. This implies that a durable tax system will need to have the flexibility to meet different governments' distributional objectives.

1.1 Scope of chapter

1.1.1 This chapter discusses principles for tax policy design. Having a clearly articulated framework and principles for tax policy design will support policy consistency over time. This will support the stability and durability of the tax system by helping to ensure that the tax system is generally understood and accepted as fair. It will also support economic outcomes by minimising uncertainty. We draw on the principles discussed in this chapter in later chapters.

1.1.2 This chapter proceeds as follows. Section 1.2 discusses the overall objectives of the tax system including introducing the concepts of fairness and efficiency. Section 1.3 discusses fairness considerations in depth. Section 1.4 discusses the costs of taxation and economic efficiency. Section 1.5 concludes.

1.2 Overall objectives of tax system

1.2.1 As noted, our focus in this LTIB is on taxes aimed at raising revenue. Traditional principles for revenue taxes, as articulated in the McLeod Review, are that the tax system should raise the amount of revenue that the government requires in a way that imposes as little cost on taxpayers as possible (that is, it is as efficient as possible) while also promoting fairness (McLeod et al, 2001a, p 5). We suggest this framework provides a helpful guide for tax policy. Using a framework based on fairness and efficiency allows us to make use of an extensive international tax policy literature and draw out insights from tax policy reviews and analysis in other countries.

1.2.2 Both fairness and efficiency give rise to several layers of considerations, which are articulated in this chapter. They are complex and multi-faceted principles. Efficiency costs can be particularly difficult to understand and measure. The Mirrlees Review suggested relying in part on some broadly attractive concepts that are likely to support the underlying goals of fairness and efficiency in most circumstances (Mirrlees, 2011, Chapter 2). Two rules of thumb we refer to in this document as guides to support fairness and efficiency are:

- Neutrality: A neutral tax system treats similar activities similarly. Tax will generally be operating in the background and have as little effect on the choices of individuals and businesses as possible.
- Simplicity: Other things being equal, a simple tax system is likely to have lower overall costs than a very complex tax system. A simple tax system is also likely to support neutrality.

1.2.3 In thinking about the design of the tax system, governments will be trading off the efficiency costs of different tax system designs with ensuring that the tax burden is distributed in a way that is generally considered fair. Ultimately, future governments will have their own views on how to best balance fairness and efficiency concerns. A durable tax system will need to be flexible enough to support a range of views by different possible future governments on fairness and efficiency trade-offs.

1.2.4 There will be no perfect framework for analysing tax policy changes. We think the framework articulated by the McLeod Review will be sufficient in most cases to identify the trade-offs inherent in tax policy design. Two alternative frameworks, which were used by the 2019 Tax Working Group (TWG), that can play complementary roles to the traditional framework by giving insights into aspects of wellbeing are the Living Standards Framework and He Ara Waiora. The latter articulates a Māori perspective on wellbeing. For example, He Ara Waiora articulates concepts relating to procedural fairness from a Māori perspective. Both frameworks can also highlight particular areas where policies may affect wellbeing by affecting things that people value. For example, both frameworks spotlight the possibility of environmental damage as an issue. They can also highlight special considerations with areas of taxation. For example, when we discuss a land tax in Chapter 6, we draw on He Ara Waiora to consider Māori perspectives. It is therefore useful to consider what additional insights these frameworks bring.

1.3 Fairness

Fairness objective

1.3.1 Fairness or equity considerations have long been a core element of tax policy analysis. There are several aspects of fairness and different ways to view what is fair.

Vertical equity

1.3.2 Vertical equity involves spreading the tax burden fairly across those with different abilities to pay. Governments that want the tax system to be based on ability to pay will want those with less ability to pay to shoulder a smaller amount than those with greater ability to pay. This will affect decisions on measures that affect the progressivity of the tax system including, for example, the structure of personal tax rates.

1.3.3 The idea that tax burdens should be based on ability to pay has a long history and appears to be widely accepted. In The Wealth of Nations published almost 250 years ago, Adam Smith writes "The subjects of every state ought to contribute toward the support of the government, as nearly as possible, in proportion to their respective abilities …".

1.3.4 The degree of progressivity is rightly a decision that future governments should be making and one on which future governments are likely to have differing views. We see the role of officials as identifying pros and cons of different objectives and supporting governments in achieving their progressivity objectives in the least cost way. Therefore, it is not a purpose of this LTIB to assess whether the current degree of progressivity is desirable or not. Here we focus on understanding the relevant principles.

Horizontal equity

1.3.5 Horizontal equity is about even-handedness and treating those in similar positions similarly. It can often be difficult to operationalise this principle. If two people have the

same income but different family circumstances or different medical conditions, are they in a similar position? It can be difficult to define those who are truly equals.

1.3.6 But horizontal equity gains a large degree of public support as a principle and most people would agree that taxes should not arbitrarily treat those in similar circumstances very differently. Horizontal equity concerns will generally push in the direction of taxing everyone as neutrally as possible, which will normally also support economic efficiency.

Fairness of process

1.3.7 Fairness of process captures concerns that the tax system should be administered fairly, and the tax rules themselves should be made in a way that is even-handed and fair. Fairness of process is important if there is to be a general acceptance that the tax system is fair. Fairness of process may have culturally specific elements. He Ara Waiora captures many aspects of fairness of process, such as tikanga (making decisions in accordance with the correct values and processes).

1.3.8 Fairness of process is helped if the government can articulate a vision of how it is setting out to design the tax system. This is recognised in the Public Finance Act 1989 requirements for governments to set out a revenue strategy articulating their objectives for the tax system and tax policy, and for these to have regard to efficiency and fairness.

1.3.9 Over the last 40 years a vision that has often been used is of a broad-base low-rate tax system where income and expenditure are taxed very broadly at as low rates as possible. The aim has been for taxes to be operating in the background as unobtrusively as possible to generate the revenue the government needs without this influencing the behaviour of individuals or firms too much – that is, the tax system is as neutral as possible.

1.3.10 Having a clear vision of the tax system articulated helps in addressing concerns that different groups of New Zealanders are being treated fairly. It allows people to hold governments to account by being able to challenge the tax rules that the government puts in place if these do not appear to tie in with the vision it is articulating. It is an important part of the process of ensuring that the tax system is not only fair but also seen to be fair.

1.3.11 An important part of fairness of process is having open debates and consultation on potential tax reforms. This is supported by having a tax system that is as transparent and certain as possible. From a He Ara Waiora perspective, tikanga requires that consultation processes uphold mana and collective stewardship; we therefore highlight the importance of transparent public engagement before any major base change.

Transitional fairness

1.3.12 Transitional fairness means limiting surprises that impose unexpected losses on those who have acted in good faith based on existing tax rules. The Mirrlees Review describes this as fairness with respect to legitimate expectations and the McLeod Review talks about transitional fairness.

1.3.13 This can be a particular concern with taxes on capital income although is also relevant to labour income. When taxes are in place they can get capitalised in prices, and this can remove horizontal inequities. As an example, suppose that a country has a single tax rate of 40% and that interest income on most bonds is fully taxable. Suppose fully taxable bonds generate a 5% interest rate but there is a special class of municipal bonds that are tax exempt. We would expect that the tax-exempt bonds will generate a 3% return and that taxpayers investing $100 in either bond will obtain an after-tax return of $3 per year.

1.3.14 Now suppose that the tax rules change and the exemption for municipal bonds is removed. Does this support horizontal equity? It means that different people acquiring bonds all pay the same rate of tax on them and that those in similar circumstances will pay similar amounts of tax. At one level this seems to be compatible with horizontal equity. On the other hand, it will mean that someone who acquired $100 of municipal bonds last year paying $3 per year (which will now only be paying $1.80 per year after tax) will now have something that is only worth $60 while someone who spent $100 on a fully taxable bond last year will still have something worth $100. This can be argued to be horizontally inequitable. It acts as a lump sum tax on wealth for one type of bondholder but not the other.

1.3.15 To address this concern, the McLeod Review suggested tax reform should be prospective as much as possible; that is, applying in respect of decisions that are yet to be made. While a useful principle, most tax changes will affect the desirability of things done in the past. For example, an increase in tax rates can affect the benefit of having studied for many years to be a doctor. But there is a potential fairness argument against measures that are likely to have large adverse effects on those who have acted in good faith based on tax rules in place in the past. There is also a potential fairness argument against reforms that provide large windfall gains. Transitional fairness concerns are likely to be alleviated to some extent if the government can articulate a long-term vision for the tax system.

Who bears the economic incidence of tax?

1.3.16 Whether a tax system is regarded as fair will depend in part on who is thought to bear the economic incidence of the tax. The economic incidence (or economic impact) of a tax has nothing to do with who is legally required to pay the tax (that is, who bears the statutory incidence of the tax). The economic incidence of a tax is on those who are made worse off by the tax. This is also relevant to where the costs of the tax ultimately fall. Economic incidence is illustrated in Box 1 by considering a tax on t-shirts.

1.3.17 The economic incidence of a tax is likely to depend on the availability of substitutes. For example, in Box 1 the incidence of the tax is shared between consumers and vendors. If there were few substitutes for consumers to buy instead of t-shirts, consumers would tend to be less sensitive to an increase in price and this is likely to increase the fraction of tax that they bear. Conversely vendors will bear a larger fraction of the tax incidence if the quantity of t-shirts they are willing to supply is less sensitive to price.

Box 1: Economic incidence of a tax on t-shirts

Suppose that initially there are no taxes and t-shirts sell at a price of $10.00. Then a tax is imposed of $2.00 per t-shirt and shops selling the t-shirts are required to pay the tax. After the tax is in place, people find that they are paying $11.50 per t-shirt so vendors end up with $9.50 after paying the tax. While vendors are liable for the statutory incidence of the tax, consumers (households buying the t-shirts) pay 75% of the economic incidence because $1.50 of the tax is passed forward to them in the prices they are required to pay.

In general, the incidence of the tax will be split between the consumers purchasing and the vendors selling the t-shirts. But once the tax is in place, who is bearing its economic incidence will often not be evident.

We know, however, that the long-run economic incidence of the tax is unlikely to depend on who is legally required to pay the tax. Suppose, say, that instead of the vendors being legally liable for the tax, consumers were liable (for example, by having $2.00 removed from their bank accounts automatically when they buy a t-shirt). The economic incidence is likely to be the same in the longer run as when the statutory incidence fell on the vendor. The registered price would end up being $9.50 with the consumer paying a total of $11.50 inclusive of tax and the vendor receiving $9.50. Provided the consumer's demand for a product depends on the total price they are required to pay (inclusive of any tax they are required to pay) and the vendor's willingness to supply a product depends on the total price they receive (net of any tax they are required to pay), the economic incidence will be independent of the statutory or legal incidence.

1.3.18 There is often likely to be a greater possibility of finding alternatives for both buyers and sellers of goods in the long run than in the short run. This means that it may often take some time for the full economic effects of a tax to materialise.

1.3.19 Note, all taxes will ultimately be paid by people. Therefore, the fraction of the burden that is borne by vendors of t-shirts will be ultimately passed on to individuals including the owners of shops, workers in shops and those supplying the t-shirts or other goods and services to the shops.

1.3.20 Economists use their best endeavours to assign the economic incidence of different taxes. However, often estimates will be approximate at best. As Mirrlees (2011, p 28) suggests "The final distribution of the tax burden is nearly always unclear to the individuals concerned and is often difficult for economists to determine." Some assumptions that are often made are:

- Personal income taxes and payroll taxes are usually assumed to be fully borne by those earning the income and subject to the tax. Gale et al (2024, p 22) comment "For income taxes, it is reasonable to claim that those who pay the tax bear the burden". For payroll taxes, the common belief is that workers end up bearing the burden both for what they pay directly, and also – in the form of wages lower than they would otherwise be – for the share nominally paid by employers. For example, in a study of payroll taxes in Canada, Deslauriers et al (2021) found that payroll taxes are passed almost entirely to workers in the form of lower wages. However, assuming the full burden of these taxes is on workers will be an approximation. An earlier meta-study by Melguizo and González-Páramo (2013), which looked at average results from a large number of prior studies, concluded that workers bear

most but not the full burden of taxes levied on labour income. For internationally mobile people with specialised skills, there is likely to be a greater proportion of tax shifted to employers.[3]

- Indirect taxes such as value added taxes (VAT) like GST are normally assumed to be fully borne by consumers purchasing goods and services. Benedek et al (2020) provide a good summary of the literature on this. They argue that the incidence of changes in the VAT rate is likely to be quite different for changes in the standard versus reduced rates. They found that full pass-through to consumer prices is broadly confirmed for a change in the standard rate but pass-through for reduced rates was noticeably lower.
- There is considerable controversy over the incidence of company income tax in a small open economy like New Zealand and the incidence will depend on the circumstances of the firm. In industries where foreign equity investors are important investors, much of the incidence of the company tax is likely to be reflected in the New Zealand business needing to generate a higher rate of return to account for the tax, so much of the tax is likely to be borne by relatively immobile domestic factors such as workers.[4] When the New Zealand firm is making better than required returns, the tax may be largely borne by the equity investors in the firms. When domestic small- and medium-sized enterprises (SMEs) are incorporated and provide a close substitute for income being earned and taxed as personal income, the incidence of the company tax is likely to be like the incidence of the personal income tax on similar individuals.

1.3.21 There will be cases where the above incidence assumptions do not hold. Suppose, for example, a government were to introduce a 10% surtax on rents paid by tenants to their landlords. This could either be levied as an indirect tax on rents or as an income tax surcharge on landlords. As Box 1 illustrates, the economic incidence of this tax should not depend in the longer run on whether it is levied as an indirect tax on rents or as an income tax surcharge on landlords. But assuming that indirect taxes are passed on to consumers while income taxes are borne by those earning the income would lead to the contrary erroneous conclusion.

Progressivity of tax system

1.3.22 A key decision for governments in meeting their distributional goals is how progressive the tax system should be. This section discusses progressivity in the context of the wider public finance system.

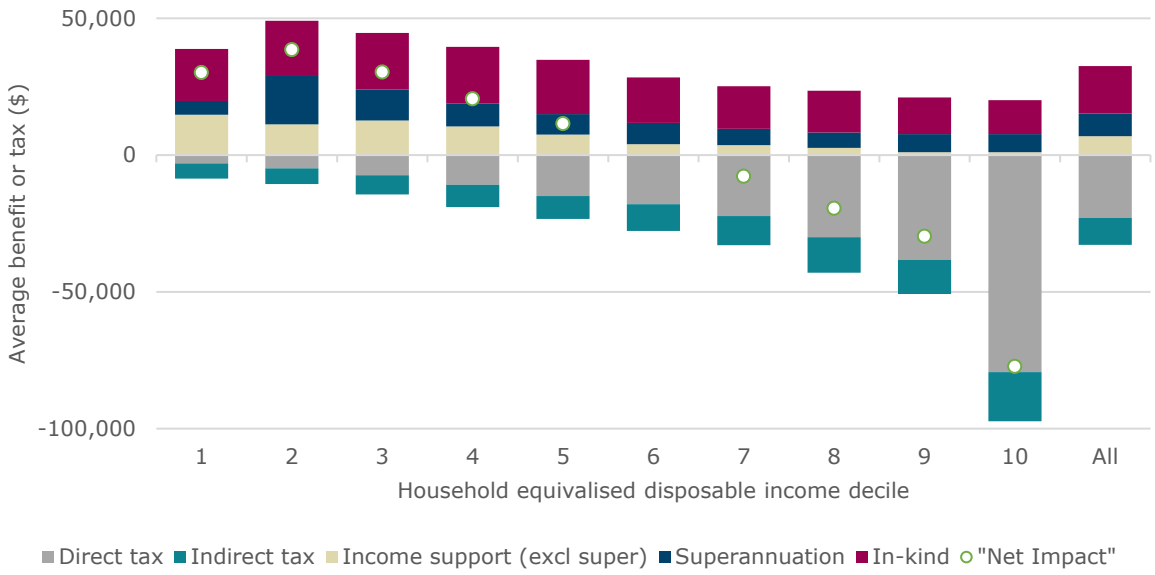
1.3.23 One of the goals of fiscal policy is to redistribute resources from the better off to the less well off. This includes redistributing from the lifetime rich to the lifetime poor and redistributing across time periods in which individuals earn income to time periods they do not (such as retirement).

[3] Note that the extent to which taxes will be passed through to employers is not a settled issue. A recent study that finds evidence of a very substantial shifting of taxes to employers for top income earners in Canada is Gordon (2020).
[4] See Inland Revenue Long-term Insights Briefing (2022).

1.3.24 The extent to which this redistribution occurs depends on the overall public finance mix; that is, the mix of taxes, transfers and in-kind expenditure. This mix is often measured in "fiscal incidence" studies.

1.3.25 The Environmental Scan (paragraphs 58 to 64) presented the results of the New Zealand Treasury's latest fiscal incidence study (Wright & Nguyen, 2024). This study estimates the distributional effects of direct (personal income tax and the Accident Compensation Corporation (ACC) levy) and indirect taxes (GST and excises), transfers,[5] and in-kind government expenditure (from health and education expenditure) across household disposable income deciles for the 2018–19 tax year (Figure 4 below).

Figure 4: Average tax and expenditure over household income deciles, 2019



Source: Wright & Nguyen (2024)

1.3.26 Figure 4 shows that the distribution of the average level of direct taxes in New Zealand is skewed towards higher-income households (grey bars), whereas the average value of indirect taxes is more evenly distributed across the population, due to GST being levied at a flat rate relative to expenditure (teal bars).

1.3.27 When considering net fiscal impacts (that is, the combined impact of taxes and government spending), the study finds that, on average, households in the first five income deciles are net recipients under the fiscal system, whereas the top four deciles pay more in taxes than they receive in expenditure on an annual basis.

1.3.28 As noted earlier, a widely accepted principle is that the amount of tax someone pays should increase with their ability to pay. A key question for governments is deciding how much tax should increase with ability to pay given they can also undertake expenditure (including transfers) to meet distribution goals.

1.3.29 It is worth noting that revenue sufficiency also requires that the amount of tax paid increase with ability to pay at least in a dollar sense. If governments required everyone

[5] Superannuation, working age income support and other transfers/tax credits.

to pay the same amount of tax irrespective of their circumstances, and if the tax requirement was low enough for everyone to pay the tax, the amount of tax revenue governments received would be very small. Hence, revenue sufficiency and ability to pay together require, at least, for the absolute value of tax to be increasing with financial wellbeing.

1.3.30 Tax systems or bases are often defined as *progressive, proportional* or *regressive*, for example:

- *Progressive income tax base:* Those with greater incomes would be required to contribute a greater fraction of their income in tax than those with lower incomes (this can be achieved with increasing marginal tax rates leading to the average tax rate increasing with income,[6] but if a lump-sum grant to each household is thought of as a negative tax payment, a government could achieve an overall progressive income tax without having a system of increasing marginal tax rates).[7]
- *Proportional income tax base:* Those with greater incomes would be required to pay the same proportion of their income in tax as those with lower incomes.
- *Regressive income tax base:* Those with greater incomes would be required to pay a smaller proportion of their income in tax than those with lower incomes.

1.3.31 Either a progressive, proportional or regressive tax system could be consistent with the absolute value of tax paid increasing with ability to pay. This is obvious for a progressive tax. Under a proportional tax, such as a proportional income tax, those on higher incomes will pay higher absolute amounts of tax. Even under a regressive tax, those on higher incomes may pay higher absolute amounts of tax although this is not necessarily the case.[8]

1.3.32 However, two arguments for a progressive tax system are:

- Paying a given amount of extra tax is likely to impose a greater cost on someone with low ability to pay than on someone with high ability to pay (put otherwise, the gain in wellbeing from retaining an extra dollar will be higher for those with lower financial resources). This would mean that, other things equal, there would be a social gain from raising revenue from those with higher ability to pay ahead of those with lower ability to pay.
- Another argument for a progressive tax system can be made on social insurance grounds. Higher incomes may to some extent reflect good luck, such as being born into a family that can provide better education opportunities or good fortune in health or other endowments. Governments may provide a beneficial element of social insurance by requiring those who do well to shoulder more of the tax burden than those who do less well. On the other hand, higher incomes can also

[6] The marginal income tax rate is the tax rate on the last dollar of income. The average income tax rate is income tax paid as a fraction of income.

[7] Whether this is desirable on fairness and efficiency grounds is open to debate. However, a system that only worked with a single rate is unlikely to be durable. Views among economists are divided on this sort of negative income tax regime. Mankiw, Weinzierl and Yagan (2009) argue that a flat marginal tax rate with a universal lump-sum grant would be close to optimal. However, Diamond and Saez (2011) argue that an optimal profile of transfers and taxes cannot be well approximated by a flat marginal tax rate together with universal lump-sum grants.

[8] For example, Figure 4 shows that the absolute value of indirect taxes (largely GST) increases across income deciles, even though the GST-to-income ratio is regressive (see Chapter 5).

represent investment in study, taking risks in the acquisition of skills or people working longer hours. There can therefore be competing considerations in considering how fair it is to tax higher incomes at higher rates.

1.3.33 There are therefore difficult choices to be made in determining how progressive the tax system should be. This will include trade-offs with efficiency considerations – discussed below. But most governments appear to prefer to raise tax in a progressive manner, and this reflects widely held views supporting progressivity of the tax system. Almost all OECD countries levy progressive marginal rates on income.

1.3.34 Having a progressive tax system does not mean that every tax base must be progressive. If more than one tax base is used, it may be sensible to achieve progressivity from the base that can promote progressivity most efficiently. A combination of a progressive personal income tax and a flat rate GST can be an overall progressive system. Where the tax system has two main bases, one that is progressive and one that is not, the relative size of those bases will be relevant to the overall progressivity of the tax system.

1.3.35 Ultimately, future governments will have different views on how progressive the tax system should be. We consider that a durable tax system will require governments to have scope to adjust tax rates in ways that reflect its views, including the ability to alter marginal tax rates on personal income to meet differing distributional objectives over time. This means the tax system needs to be resilient enough to tolerate a range of different marginal tax rates on different levels of income.

Challenges in measuring progressivity

1.3.36 While governments may have an overall goal of a progressive tax system, there are considerable challenges in measuring and defining how to assess progressivity. Progressivity measures can differ significantly depending on the base and period of assessment. The definition of the base of assessment (for example, if income is used, whether it is comprehensively defined) can also significantly alter the result.[9]

1.3.37 The progressivity of the tax system is most often measured by considering total tax paid relative to total annual income (that is, by looking at average tax rates). However, there are conceptual difficulties in looking at consumption taxes such as GST relative to annual income. These difficulties arise for two reasons:

- Consumption smoothing: People accumulate and run down savings over time. Whether or not people have low lifetime incomes, they will tend to spend less than they earn in periods when their incomes are relatively high (for example, working years) to accumulate savings to spend when their incomes are relatively low (for example, retirement years). This smooths consumption spending through time. This can make the GST appear regressive on an annual income basis even if it is proportional with respect to lifetime income. This is illustrated in Box 2.

[9] Issues with the definition of income in assessing the distribution of the tax burden were discussed in (Ching et al (2023) and Inland Revenue (2023)).

- Bequest motives: High lifetime income earners may often spend less than they earn throughout their lifetimes so that they are able to leave larger bequests.

Box 2: Anna and Bob, consumption smoothing and tax progressivity

Consider two people Anna and Bob. To make things simple, assume they live for two periods only and there is a 10% interest rate. Anna earns $100 of wage income in the first period and no wage income in the second, while Bob earns $50 of wage income in the first period and $55 in the second. The present value of wage income for both Anna and Bob is $100 (for Bob this is $50 for the first period plus $55/1.1 for the second given the 10% interest rate).

Now suppose that we introduce a consumption tax of 20% of gross expenditure and that both individuals consume all their income over their lifetimes. Suppose that Bob chooses to spend everything he earns in each of the two periods. In this case he spends $50 in the first period, which purchases $40 of real goods and services (and tax of $10 is paid in that period). He spends $55 in the second period, which purchases $44 of real goods and services with $11 of tax being paid in that period. For Bob, the consumption tax looks proportional because Bob is paying 20% of income earned in each period.

Now consider Anna. She could, if she wished, spend $100 in the first period and nothing in the second and the tax would appear proportional. Suppose, however, that she chooses to spend $50 in the first period and save the remaining $50. This gives her $5 of capital income in the second period, which allows her to spend $55 in the second period just like Bob. As a result, she pays $10 of tax in the first period and $11 of tax in the second period just like Bob.

For Anna this tax looks regressive. She pays $10 of tax in the first period when her income is $100 so the tax is 10% of income in that period. She pays $11 of tax in the second period when her income is $5 so the tax is 220% of income in that period. She ends up paying a low tax rate when income is high and a high tax rate when income is low, and this appears to be regressive.

But Anna's tax looks regressive not because Anna is being taxed unfairly relative to Bob but merely because she is smoothing her consumption. Looking at consumption taxes relative to annual income can give misleading results because it does not take account of the impact of savings behaviour.

1.3.38 The Mirrlees Review suggested looking at different taxes in respect of their base (Mirrlees, 2011, p 26); that is, looking at income taxes as a percentage of current income and expenditure taxes as a percentage of current expenditure. This is possible if looking at a base by itself. However, estimating aggregate distributional effects on a consistent basis requires a comparable base and for this reason assessment of the tax system as a whole is often undertaken by looking at tax paid relative to total income.

1.4 Costs of taxation and economic efficiency

1.4.1 Most taxes will impose costs on taxpayers that are greater than the revenue that the government ultimately receives from the taxpayers. These are often described as efficiency costs (or excess burdens or deadweight losses). Raising tax revenue at minimum cost means keeping these efficiency costs as small as possible. Efficiency costs do not mean that raising tax revenue to finance government spending is a bad idea; just that the benefit of any public spending should be sufficient to cover both the direct dollar costs of the tax and any excess burdens.

1.4.2 We follow the approach of many international tax reviews and include in efficiency costs: distortionary costs from behavioural changes, compliance costs incurred by taxpayers and administration costs incurred by the government. The total cost of paying tax for taxpayers will be the sum of the tax payments that the government receives plus the efficiency costs of raising the tax revenue.

Distortionary costs

1.4.3 Of the three types of efficiency costs, distortionary costs are the most complex.[10] They arise because of the way that taxes change relative prices and thereby change decisions and cause people to do things that would not be their first choice in the absence of taxes, but are done to pay less tax. They are multi-faceted and arise in many different circumstances. These costs depend on what people value, so this concept is broad enough to take account of people's differing cultural values. The cost arising from distortionary costs represents a loss of wellbeing.

1.4.4 An extreme example of distortionary costs is a tax on running shoes that is set so high that nobody chooses to buy running shoes. In this case, the tax would clearly raise no revenue. But this does not mean that the tax is costless. It is costly to those who want to buy running shoes but are deterred from doing so by the level of the tax.

1.4.5 Box 3 discusses the excess burden that can arise with a more moderate tax on t-shirts. The example explains how the tax can cause people to consume fewer t-shirts. The distortionary costs arise in respect of the t-shirts that are no longer consumed. On these t-shirts no tax is being raised but there is nonetheless a cost to taxpayers because the tax leads to people no longer buying t-shirts that would be worth more to them than what it costs to produce them.[11]

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[10] Keen and Slemrod (2021) discusses distortionary efficiency costs (see pp 17–22 and 222–223) and our discussion of excess burden draws on their analysis.

[11] When considering efficiency costs, economists distinguish between the income and substitution effects. First, the increase in the relative price of t-shifts will have a substitution effect causing consumers to substitute away from t-shirts towards other goods and services. Second, paying the tax can have an income effect because paying the tax makes consumers poorer. Both the income and substitution effects will affect the number of t-shirts bought but the excess burden will depend only on the substitution effect. The income effect is an inevitable consequence of paying tax and would arise even if there were a lump-sum tax on consumers that did not distort consumption decisions. A full measure of the efficiency gain for consumers from removing the tax is the amount people would be willing to pay to get rid of the tax minus the amount of tax the government is initially obtaining from them.

Box 3: Excess burden of a tax on t-shirts

Suppose, as before, a tax of $2.00 per t-shirt increases the price that consumers pay from $10.00 to $11.50 and reduces the price that vendors receive from $10.00 to $9.50. Also suppose that this reduces the number of t-shirts that are purchased each week from 1,000 to 800. The distortionary cost arises in respect of the 200 t-shirts that are no longer purchased. For the 800 t-shirts that are still being purchased each week, $2.00 per t-shirt is being paid in tax. This cost matches the revenue being received by the government (compliance costs and administration costs aside) and this is just a transfer of revenue within society. Therefore, there is no distortionary cost in respect of the t-shirts that continue to be purchased.

The distortionary efficiency cost arises because there are 200 t-shirts no longer being purchased. When 1,000 were purchased, those purchasing a shirt were willing to pay at least $10.00 per shirt. When 800 are being purchased, those doing so are willing to pay at least $11.50. The t-shirts no longer being purchased were therefore worth something between $10.00 and $11.50 to the consumers who were previously purchasing them, say, on average $10.75. By no longer purchasing 200 shirts that previously cost $10.00 but were worth $10.75 on average, consumers are missing out on about $150 of value ($0.75 x 200).

Similar reasoning suggests that vendors are missing out on about $50.00 of value. When firms were providing 1,000 shirts, they were willing to do so at a price of $10.00 but they are only willing to provide 800 at a price of $9.50. This means that they required a price between $9.50 and $10.00 (say, an average of $9.75) to provide the t-shirts they are no longer providing. So, they are no longer providing 200 shirts that required an average compensation of about $9.75 to be produced but they were receiving $10.00 per shirt in the absence of tax. Therefore, they are worse off by $50.00 ($0.25 x 200) in respect of the t-shirts that are no longer being sold.

In this example the tax raises $1,600 but creates an excess burden of about $200 because sales that were valuable to both buyers and sellers are no longer taking place.

1.4.6 There are two further points to note about these distortionary excess burdens. First, the more responsive the quantities purchased are to changes in prices, the greater the excess burden will be and the smaller the tax revenue raised will be. This is illustrated in Box 4.

Box 4: Excess burdens increase with price responsiveness

Suppose, as before, that when no taxes are in place the price of t-shirts is $10.00 and 1,000 per week are purchased. Also suppose (as before) that a tax of $2.00 is imposed and that this raises the price paid by consumers to $11.50 and reduces the price received by vendors to $9.50. This time, however, assume that it reduces the number of t-shirts purchased to 600 a week. Now the tax raised will be $1,200 (600 x $2.00) while the excess burden will be about $400 (400 x $1.00). If supply and demand of t-shirts are more responsive to price, the excess burden of a tax will tend to be larger.

1.4.7 A second point to note is that these distortionary excess burdens will tend to rise more than proportionately with increases in tax rates. Other things being equal, doubling the tax rate will approximately quadruple the excess burden. This is shown in Box 5.

Box 5: Doubling tax rate approximately quadruples excess burden

In Box 3, a tax of $2.00 per shirt created an excess burden of approximately $200. Now consider the effects of an increase in the tax rate to $4.00 per shirt using the example in Box 3. Assume that this raises the price paid by consumers to $13.00, reduces the price received by vendors to $9.00, and this reduces purchases to 600 (that is, it has double the effect on consumption of a $2.00 tax). Now the tax is bringing about a reduction of 400 in the number of t-shirts purchased. The excess burden will be about $800 ($2.00 x 400, assuming an average value of t-shirts not purchased by consumers of $11.50 and an average value of t-shirts not sold by vendors of $9.50), which is four times the excess burden of a $2.00 tax. Therefore, doubling the tax rate will approximately quadruple the excess burden. At the same time tax raised ($2,400) is less than double that raised in Box 3 ($1,600) because the quantity of t-shirts purchased will fall.

The marginal excess burden of tax (the additional excess burden incurred to raise an additional dollar of tax) will increase as the tax rate increases.

1.4.8 While we have used a tax on the purchase of t-shirts to illustrate the concept of excess burden, similar issues will arise with many other types of taxes. There are many margins on which taxes can create efficiency costs, including through influencing decisions on:

- Whether to work or not, how many hours and in what type of job to work, and whether to work in paid or unpaid activities.
- Whether to undertake study to increase one's earning power in the future.
- Whether to consume now or save to increase consumption in the future.
- Whether and how much firms choose to invest and what firms invest in.
- What type of savings people undertake (for example, rental properties, interest-earning deposits or shares).
- The level of tax compliance.

1.4.9 Distortionary costs represent a loss of wellbeing to New Zealanders. In some cases, this will be because of reduced productivity and economic growth. But taxes can be distorting even if they have no effect on GDP. An example is a tax on red t-shirts that resulted in people supplying and purchasing blue t-shirts instead of red. While production might be the same, wellbeing would be lower if people preferred red t-shirts to blue.

Why excess burdens are minimised with broad tax bases

1.4.10 Economics literature supports the idea that broad tax bases reduce distortionary efficiency costs. A stream of literature supporting this proposition examines the "elasticity of taxable income", that is, how an increase in income tax rates can reduce the taxable income base. For example, Feldstein (1995) and Feldstein (1999) argue that because excess burdens are multifaceted, a small increase in income tax rates can reduce the income tax base because people decide to work less. But it can also affect the base on many other margins such as those discussed in paragraph 1.4.8.[12] All these

[12] A widely cited study that draws on this analysis is Saez, Slemrod and Giertz (2012).

margins of decision are part of the multifaceted ways in which taxes can impose efficiency costs.

1.4.11 The taxable income elasticity literature provides strong economic efficiency grounds for designing tax bases that are as broad as practicable. This includes broadly taxing consumption under the consumption tax and broadly taxing income under the income tax. The broader the income tax base, the fewer the opportunities for activity to be diverted to lesser taxed and less productive activities.[13] This also supports the principle of neutrality as a general guide to designing taxes with low economic cost.

1.4.12 Note that while neutrality provides a general guide to designing a low-cost tax system, there can at times be conflicts in the concept of neutrality. Tax bases that are neutral on some margins may not be neutral on others. A key consideration discussed in later chapters is the choice between a general income tax and a consumption tax. A comprehensive general income tax levied on both capital and labour income would, in principle, be neutral between the taxation of different forms of income but it would lead to a higher present value of taxes on consumption that is delayed leading to non-neutrality regarding the timing of consumption. This shows the importance of defining the tax base under consideration and what it is that one wants to be neutral about.

1.4.13 Further, at times it may be desirable to depart from neutrality, such as:

- If people creating social costs are not taking account of the full social cost of their actions, this can provide a potential case for levying a corrective tax (Section 6.8).
- If the focus is on economic efficiency, there can be a potential case for higher taxes on activities when supply and demand are not very responsive to price changes.
- Even if there is a general goal to tax income as neutrally as possible, it may be desirable to not tax some forms of income if doing so would have high compliance costs. This shows that there can be a trade-off between neutrality and simplicity.

1.4.14 Good tax administration can also be important in supporting economic efficiency and can lower the elasticity of taxable income (Slemrod and Kopczuk, 2002). Similarly, high levels of voluntary compliance can be important in promoting economic efficiency. This is more likely if taxes are considered fair and if the tax system is as simple as possible.

Compliance and administration costs

1.4.15 Compliance and administration costs are also efficiency costs.

1.4.16 *Compliance costs* are the costs borne by taxpayers in complying with tax rules. Compliance costs increase the burden of paying tax on taxpayers relative to the amount that the government gains in tax revenue. Included in compliance costs are the costs that taxpayers incur to find out whether they are required to pay tax and costs that arise from taxpayers attempting to avoid or evade tax. Compliance costs will tend to

[13] For example, if a person faces a 30% marginal tax rate on their income and has $10,000 to invest, which can produce $500 of fully taxed income, the benefit of this will only be $350 to them while the benefit to New Zealand will be $500. If there is an alternative investment that is untaxed and provides $351 of benefit, the person will have an incentive to invest in that ahead of the fully taxed investment. New Zealand will be worse off by $149.

rise if the tax law is complex or uncertain and may rise with tax rates because higher tax rates will increase incentives for people to avoid or evade tax.

1.4.17 *Administration costs* are costs incurred by the government in administering the tax system, including the costs of providing tax policy advice. Administration costs are also likely to rise if the law is uncertain or complex. Administration costs can rise if compliance is poor, and this creates additional costs to the government in attempting to stem tax avoidance and evasion.

1.5 Conclusion

1.5.1 To summarise, we consider that the traditional framework of the tax system, raising the amount of revenue required in a way that imposes as little cost on taxpayers as possible while also promoting fairness, provides a helpful guide for tax policy. Under this framework, different governments will be making different trade-offs between efficiency and fairness concerns over time.

1.5.2 Some governments are likely to place a greater weight on distributional concerns than others. These governments may be willing to have a somewhat less efficient tax system with higher economic costs than other governments to achieve what they consider to be a fair distribution of the tax burden.

1.5.3 A durable tax system requires that future governments be able to change the tax system in ways that support their fairness concerns in the least cost way. This implies that a durable tax system needs to have sufficient distributional flexibility to accommodate different governments' views on how much the tax burden should increase with ability to pay.

Chapter 2 – Overlapping tax bases

Overview

This chapter analyses tax bases by considering what fundamental economic factors they aim to tax. This helps us to understand the overlaps and differences between different tax bases and can therefore help in comparing different tax bases. Chapter 3 then examines the pros and cons of taxing these underlying economic factors and the implications for tax system design.

Different tax bases can be analysed in terms of how they aim to tax the fundamental economic factors of labour income, existing wealth, and different forms of capital income. The forms of capital income are a normal or risk-free return (the return from delaying consumption), a risk premium to compensate for risk and economic rents (returns in excess of the risk-free rate and compensation for risk).

The bases we look at first are a labour income tax, a general income tax that taxes both labour and capital income, a consumption tax, and a general income tax with a rate of return allowance (RRA) – or deduction – for the normal return. These taxes are similar in that they all effectively tax labour income but differ in how they tax capital income. The impacts of these taxes on the underlying economic factors can be summarised as:

- Labour income: A labour income tax, general income tax, general income tax with an RRA, and consumption tax would all tax labour income or do something that is economically equivalent.
- Normal return: A labour income tax and a general income tax with an RRA would not tax normal returns. The same is true of a consumption tax, if levied at a constant rate through time. By contrast a general income tax would tax normal returns.
- Economic rents: Of these four tax bases, all except a tax on labour income only would tax economic rents.
- Risk: If levied at a flat marginal rate with full loss offsets, a general income tax, general income tax with an RRA, and consumption tax would all involve the government sharing in risk rather than levying a burdensome tax on risk. But, with progressive marginal tax rates and limited loss offsets, these taxes would discourage investment in risky but potentially high-return activities.

We then extend the analysis to a wealth tax or a risk-free return method tax. These taxes would tax normal returns but do not tax economic rents and the government would not be sharing in the risk of investments. These taxes have no equivalence with labour income taxes.

We also extend this framework to a dual income tax. This has the same base of taxation as a general income tax and therefore aims to tax normal returns, economic rents and labour income. However, it differs from a general income tax in that it taxes normal returns at a lower rate than labour income and economic rents.

The introduction of a consumption tax such as GST or an increase in its rate may also impose a lump sum tax on some but not all forms of existing wealth.

2.1 Scope of chapter

2.1.1 This chapter looks at what fundamental economic factors are taxed under different tax bases and the overlaps and differences between key tax bases. This helps us to understand the pros and cons of different tax system designs or different approaches to meeting future revenue needs.

2.1.2 This approach can be helpful, for example, in considering questions such as whether an additional tax on labour income or increasing New Zealand's rate of GST would be a better approach if more tax revenue is required. There is considerable overlap but also some key differences between these options.

2.1.3 This chapter proceeds as follows. Section 2.2 sets out the key underlying factors of labour income, different forms of capital income and existing wealth. Section 2.3 describes the four idealised tax bases that we analyse first: a tax on labour income, a general income tax, a consumption tax, and a general income tax with a rate of return allowance. Section 2.4 provides a comparative analysis of these bases in terms of how they tax the underlying factors. Section 2.5 extends the analysis to a wealth tax, or a risk-free rate of return tax, and a dual income tax. Section 2.6 concludes.

2.1.4 Having understood what is taxed under various tax bases, Chapter 3 then considers the pros and cons of taxing these underlying economic factors and the implications for the tax mix. This framework is also helpful in assessing alternative tax bases in Chapter 6.

2.2 Key concepts

2.2.1 As shown in Figure 3, OECD countries gather the vast majority of their tax revenue from labour income taxes, general income taxes and general consumption taxes. The composition of tax structures varies considerably across OECD countries. For example, many OECD countries have specific taxes on labour income, whereas New Zealand relies more heavily on a general income tax that taxes both labour and capital income under a single framework. In 2022, 18 OECD countries derived the largest share of their tax revenues from income taxes (encompassing both personal and company tax), while 11 countries relied primarily on SSCs. In nine countries, consumption taxes, including VAT, were the dominant source of revenue (OECD, 2025).

2.2.2 However, there are both overlaps and differences in what these different tax bases tax. Taxes on income and consumption can be distinguished in terms of their effect on some more fundamental tax bases. We will refer to these as **underlying economic factors**. When considering if a particular tax base is desirable, it is useful to understand what underlying economic factor (or factors) it is taxing. This allows consideration of how that tax base fits within the overall tax mix alongside other tax bases.

2.2.3 This chapter first examines the similarities and differences between four idealised tax bases in terms of how they tax the underlying economic factors of labour income,

existing wealth and different types of capital income.[14] The different types of capital income are:

- A "normal" or risk-free return is the amount that people require in compensation for putting off consumption without any additional returns to compensate for risk bearing. This can be thought of as the return from a safe interest-bearing asset.
- Economic rents (sometimes also referred to as inframarginal or supernormal returns) are returns in excess of what is required to compensate for delayed consumption and risk.
- The return to risk is the premium over and above the risk-free rate that is required to compensate investors for the costs of investing in risky activities.

2.2.4 The aim of the discussion is not to discuss practical design issues that may make any of the bases difficult or impractical to implement. It is to discuss a benchmark for starting to analyse similarities and differences between the taxes. Practical difficulties in implementing taxes on capital income are discussed in later chapters.

2.2.5 This LTIB focuses on the taxation on domestic residents and therefore our focus here is on the capital income of domestic residents (savings). However, the taxation of non-resident investment is touched on briefly in Chapter 3, and Chapter 4 discusses the taxation of non-resident investment in the context of the design of an income tax.

2.3 Four idealised tax bases

2.3.1 The four idealised tax bases that we examine first are:

- tax on labour income only (LIT)
- general income tax on both labour and capital income (GIT)
- consumption tax (CT), and
- general income tax combined with a rate of return allowance (RRA) for the normal return (GITR).

2.3.2 Variants of the first three of these taxes are common internationally and the fourth was suggested as a possible reform by the Mirrlees Review in the United Kingdom (UK). Section 2.5 extends the analysis to a wealth tax or risk-free return method (RFRM) tax and a dual income tax.

2.3.3 ***Labour income tax*** (LIT) only taxes labour income. Labour income includes salaries and wages as well as the compensation that the owner of a business obtains as a reward for the work that is put into running a business. New Zealand does not have an LIT (except the ACC levy), but many countries have variants of taxes that are aimed at taxing some forms of labour income only, including social security contributions (SSCs) and payroll taxes. LITs are discussed in more detail in Chapter 6.

2.3.4 ***General income tax*** (GIT) is a tax on the sum of labour and capital income. A comprehensive tax on general income (sometimes described as a tax on economic

[14] This draws on Meade (1978), Mirrlees (2011, chapter 13) and Weisbach (2004).

income) is often defined as a tax on "the amount that could be consumed in a period while leaving wealth unchanged". Wealth could be measured in real or inflation adjusted terms.[15] Alternatively, it can be thought of as the amount that wealth would have increased by in the absence of any spending on consumption. Given this definition, under a GIT, returns both in the form of cash income received as well as any accrued capital gains would be considered income. The analysis in this chapter assumes all income is taxed under a GIT, although as we discuss later there are practical constraints on taxing all income comprehensively.

2.3.5 ***Consumption tax*** (CT) might be:

- A direct consumption tax or direct expenditure tax (DET) – an individual's consumption expenditure is measured (and taxed) as income minus savings. Under a DET, individuals would be taxed on their consumption expenditure in much the same way as they are taxed on their income at present (except that amounts saved are not taxed) and this could be taxed at progressive marginal rates. DETs are discussed more in Chapter 5.
- An indirect consumption tax such as New Zealand's GST – tax is withheld when goods and services are acquired for consumption. Indirect consumption taxes take no account of the personal circumstances of consumers. The analysis in this chapter assumes that if the CT was levied as an indirect tax, this would be an indirect CT with a single rate for all consumption with no exemptions.

2.3.6 ***General income tax with a rate of return allowance*** (GITR) is helpful to analyse because it has very similar properties to a CT. It helps clarify similarities and differences between income taxes and consumption taxes. The GITR is a general income tax combined with a *rate of return allowance* (RRA). The RRA is a deduction equal to the risk-free rate of return multiplied by capital invested (that is, the normal return is excluded from taxation).

2.3.7 The key difference between these tax bases is in how they tax the capital income of domestic residents; that is, the return to savings. One way to look at this is to look at the different points of taxation of these taxes. This is often analysed by considering a taxpayer who earns some labour income in an initial year and who then saves the after-tax income before spending it at some time in the future. The point of taxation can be analysed in terms of what happens in the following three stages of the savings process:

- Stage 1 – income is received (that is, at the point that labour income is earned, at or before the time it is put into a savings account).
- Stage 2 – capital income is accumulating prior to savings being withdrawn and spent.
- Stage 3 – savings are withdrawn and spent on consumption goods or services.

2.3.8 We can define the point of taxation under the four tax bases using the notations T (taxation) and E (exemption). Table 1 shows the points of taxation under the four bases.

[15] If real wealth was left unchanged, we would have a tax on real economic income and if nominal wealth was unchanged, we would have a tax on nominal economic income.

Table 1: Comparison of points of taxation under different tax bases

Labour income tax (LIT)	TEE	Labour income is taxed as earned but the return to savings is excluded from taxation. There is no tax when income is spent, or savings are withdrawn.
General income tax (GIT)	TTE	If a taxpayer earns labour income and saves the proceeds, the initial earnings are taxed when labour income is earned and the return to savings are taxed. There is no tax when income is spent, or savings are withdrawn.
Consumption tax (CT) *Direct or indirect*	EET	Tax is only paid on income used for consumption at the time it is spent.
General income tax with a rate of return allowance (GITR)	TtE	Labour income is taxed as earned. The lower case "t" in the middle reflects that income that accrues on savings is only being partially taxed because the normal return is not taxed. There is no tax when income is spent, or savings are withdrawn.

2.4 Comparative analysis of the four tax bases

2.4.1 We now consider how labour income, different forms of capital income, and existing wealth are taxed under the four idealised tax bases discussed in Section 2.3.

2.4.2 To do so, we examine the effects of the four idealised tax bases under three scenarios:[16]

- When there is no uncertainty and savings earn a standard risk-free rate of return, and nobody can earn economic rents.
- When there is no uncertainty, but some people earn economic rents (more than a risk-free return) on their savings.
- When returns on savings are uncertain and taxpayers require a risk premium when they invest in risky assets to compensate for risk.

No economic rents and no uncertainty

Key conclusions

- LIT, GIT, GITR and CT all tax labour income equivalently.
- GIT taxes the normal return on savings whereas LIT, GITR and CT do not.
- CT potentially imposes a lump-sum tax on some forms of wealth the day the tax is imposed or if the rate is changed.

2.4.3 It may be obvious that a tax on labour income only (LIT), a general income tax on both capital and labour income (GIT) and a general income tax on both capital and labour income with an RRA (GITR) all tax labour income. It may also be obvious that the GIT would tax the normal return while the LIT and the GITR would not. It is perhaps less obvious that a CT (such as New Zealand's GST) does something equivalent to taxing labour income but exempting normal returns. A CT results in the same after-tax

[16] Breaking the analysis down in this way borrows from Weisbach (2004).

consumption opportunities as other taxes that tax labour income but exempt normal returns. For this reason, we will describe the tax as taxing labour income but exempting the normal return.

2.4.4 To consider the four types of tax we start by considering the effect of each tax base in a simple example. Suppose an individual earns $10,000 of labour income at the end of year 0. This can be spent immediately or saved. We look at how much tax is paid and after-tax consumption under each of the four tax bases. The tax rate under each tax is assumed to be 20%. If we are thinking of the consumption tax as an indirect tax, this tax rate is assumed to be 20% of the gross price (for example, if a good sells for a gross price of $125, $25 is paid in tax leaving the seller with a net price $100). This is a tax of 20% of the gross price or 25% of the net price.

2.4.5 Table 2 shows the effect of the four possible tax bases. In each case we consider what happens if income is all spent at the end of year 0 or if income is saved for a year and then spent at the end of year 1. If earnings are saved, they are assumed to earn a 4% risk-free interest rate (the normal return).

Table 2: The four tax bases compared – 4% return

	LIT	GIT	GITR	CT
Earnings spent in year 0				
Earning year 0	10,000	10,000	10,000	10,000
Less LIT/GIT/GITR	2,000	2,000	2,000	0
Less CT	0	0	0	2,000
Net consumption year 0	**8,000**	**8,000**	**8,000**	**8,000**
Earnings saved in year 0 and spent in year 1				
Earnings year 0	10,000	10,000	10,000	10,000
Less LIT/GIT/GITR	2,000	2,000	2,000	0
Savings and investment	8,000	8,000	8,000	10,000
Capital income year 1	320	320	320	400
RRA deduction	0	0	320	0
Less LIT/GIT/GITR	0	64	0	0
After-tax capital income	320	256	320	400
Consumption spending before CT	8,320	8,256	8,320	10,400
Less CT	0	0	0	2,080
Net consumption year 1	**8,320**	**8,256**	**8,320**	**8,320**
Rate of return on deferred consumption	**4.0%**	**3.2%**	**4.0%**	**4.0%**

2.4.6 Note first, that if the earnings were spent in the initial year so there is only labour income, all four tax bases would levy $2,000 of tax and allow $8,000 of consumption in that year. That is, without savings, the taxes are identical. They tax labour income equivalently.

2.4.7 However, if earnings are saved with an LIT or with a GITR there would be no tax on capital income in year 1. In both cases $8,000 of after-tax income would be saved in

year 0, which would produce a 4% return of $320 on which no further tax would be levied. In both cases the normal return would not be taxed in year 1 allowing net consumption of $8,320. Net consumption is 4% higher than it would be if consumption had taken place in the initial year, so net consumption opportunities are growing at the pre-tax rate of interest of 4% (meaning the present value of consumption is the same as it would have been if consumption had taken place in year 0).

2.4.8 By contrast under a GIT, the normal return of $320 is taxed. Therefore, $64 is paid in tax on the savings income and the taxpayer gains $256 of after-tax income. By deferring consumption for a year net consumption grows by 3.2% rather than 4% – saving $8,000 boosts after-tax consumption to $8,256. The normal return is being taxed.

2.4.9 LIT and GITR are sometimes described as being **savings neutral** because they do not tax the normal rate of return. By contrast, GIT is not savings neutral because it does tax the normal rate of return, which will tend to discourage saving.[17]

2.4.10 For CT, if the individual earns $10,000 and saves this, no CT is paid in year 0. The $10,000 of saving generates $400 of capital income in year 1 allowing before-CT spending of $10,400. This will lead to CT of $2,080 in year 1 rather than the $2,000 of tax that would have been paid if the $10,000 had been spent in year 0. But the present value of the tax liability (and after-tax consumption) is the same as would be the case if tax had been paid in year 0 ($2,080/1.04 = $2,000).

2.4.11 In economic terms, labour income is being fully taxed under CT whether income is spent in year 0 or year 1. Delaying consumption means that rather than having net consumption of $8,000 in year 0, the individual enjoys $8,320 of consumption in year 1 (an increase in net consumption of 4% equal to the normal return). CT is **savings neutral** just like LIT and GITR. Unlike GIT there is *no tax on the normal return*.

2.4.12 There are some important qualifications to the savings neutrality of a CT including:

- *Savings neutrality of CT requires a constant tax rate.* The key reason why CT is neutral with respect to savings decisions is that consumption is being assumed to be taxed at the same rate in both years 0 and 1. If the CT rate is expected to vary over time this neutrality will not hold.
- *CT can impose a lump-sum tax on existing wealth held on the day CT is introduced or increased.*[18] To see this, suppose that all wealth is in financial assets such as savings in a bank account. In this case a CT would impose this lump-sum tax. If the wealth is spent immediately, it will be taxed immediately. If it is saved, and the savings plus accumulated return are then spent, the wealth will be taxed in the future. But in either case the present value of existing wealth will be subject to the

[17] When we say that savings are being discouraged, we are meaning that there is a substitution effect discouraging savings. Incentives to save are discouraged relative to what would be the case if the same present value of tax collections was raised in a way that did not distort savings decisions (see footnote 25)

[18] This feature of a consumption tax can have important implications for economic efficiency. For example, Auerbach, Kotlikoff and Skinner (1983) estimated that this would lead to a switch from a general income tax to a consumption tax in the United States increasing steady-state welfare by almost 2% of lifetime resources while a switch from a general income tax to a tax on labour income only would lower steady state welfare by more than 2% of lifetime resources. The difference between LIT and CT is a result of the efficient lump-sum tax on existing wealth.

tax. So, a comprehensive tax on consumption would not only tax future labour income whenever it is spent, it would also reduce the purchasing power of existing wealth. For this reason, a CT is sometimes described as a tax on labour income plus a lump-sum tax on existing wealth. An indirect CT like New Zealand's GST typically imposes a lump-sum tax on wealth held in financial assets when the tax is first imposed or when it is increased. However, owners of existing housing or other durable assets are likely to be insulated from this lump-sum tax.[19] Whether or not a DET levies a lump-sum tax on wealth depends on whether existing savings are carved out from the new tax or not.

- *Migration and bequests.* In the example it is assumed that under a CT, labour income earned in year 0 ends up subject to CT when the savings are spent on consumption. But if someone earns labour income in New Zealand and migrates before any earnings are spent, New Zealand will not end up levying GST (although another country might do so). Also, under a GST some goods and services, such as consumption expenditure incurred while on holiday overseas, will not be subject to the tax.[20] Conversely, migrants coming to New Zealand with savings or tourists on holiday in New Zealand can be subject to GST when they purchase goods or services in New Zealand. Commentators often note that those who earn labour income, save it and then leave it as a bequest will not be subject to GST. While this reduces the lifetime tax impost on the individual earning the initial income, the bequest will generally be subject to tax in the beneficiary's hands if the beneficiary resides and spends the bequest in New Zealand.

2.4.13 While qualifications to the basic story are important, a key insight is that LIT, GITR and CT can be thought of as equivalent taxes on labour income while leaving the normal return to capital income untaxed (provided in the case of CT that the rate of CT does not change). By contrast GIT will tax both the normal return to capital and labour income. Unlike LIT, GIT or GITR, CT may impose a lump-sum tax on some forms of existing wealth when CT is first imposed or its rate increases.

[19] Any increase in the rate of GST will apply to both the construction of new houses and to any land used for new houses. If this is passed on in higher house prices, the value of existing housing is also likely to increase reflecting the higher cost of new housing. If that happens, owners of existing housing can be insulated from the one-off wealth tax. Owners of other consumer durables can also be insulated from the one-off wealth tax effects. Instead, the tax impost is likely to be passed to future purchasers of existing housing and other consumer durables. Housing and land including rental property is roughly 60% of gross household wealth (Stats NZ Household Balance Sheet).

[20] This need not be the case under other forms of CT. For example, under a DET, consumption is measured by the difference between income and savings. Consumption both at home and overseas is likely to be captured when savings are subtracted from income to measure consumption.

Economic rents but no uncertainty

Key conclusions

- With LIT, economic rents will not be taxed.
- With GIT, GITR and CT, economic rents will be taxed.

2.4.14 In the discussion above it was assumed that all savings generated the same 4% rate of return – the normal return. There are two potential reasons for people to be earning higher average rates of return on their savings. One is that they are investing in risky assets, and a risk premium is required to compensate them for the risk they are taking on. This possibility is discussed later. Here we look at the possibility of some taxpayers being able to make better than normal returns (or economic rents) because, for example, of specialised skills, knowledge or talents.

2.4.15 Economic rents are likely to be important for some investments, especially the investments undertaken by able business proprietors. Workers differ in labour productivities, and this results in different workers earning different wage rates. Similarly, there is likely to be a difference in the skills of different business proprietors and more skilful proprietors are likely to be able to make better than normal returns on their investments.

2.4.16 There is international evidence that some individuals earn returns on their wealth that are consistently higher than average and returns on wealth tend to increase with the level of wealth. Fagereng et al (2020) examine Norwegian data and find evidence of persistent higher returns generated by those who are wealthy. They attribute this, in part, to entrepreneurial talent.[21]

2.4.17 In practice, however, investment options on which economic rents can be generated are likely to be limited. Otherwise, there would be no bounds to the wealth that could be accumulated by business proprietors who could borrow at the normal return and earn more than this when they invest the borrowed funds.

2.4.18 Table 3 examines the effect of LIT, GIT, GITR and CT if there are two sets of individuals who invest $10,000. The first set of individuals makes a normal return of 4% (or $400) on their savings and the second earns a higher 10% return (or $1,000). This 10% comprises the 4% normal return plus a 6% economic rent ($600).

2.4.19 The tax base that is levied will not affect the quantity of investment on which a business proprietor is able to generate economic rents. To take this into account, we assume that the same amount ($10,000) is invested under all the possible tax bases. This requires the taxpayer to forgo consumption of $10,000 in year 0 under LIT, GIT or GITR and consumption of $8,000 under CT.[22]

[21] There are differences in view about whether higher returns reflect greater skills by investors. Bach et al (2020), drawing on Swedish data, find substantial differences with returns increasing with wealth but attribute this largely to risk exposure.
[22] To keep the table as simple as possible we no longer record the amounts of labour income that would be required to finance the investment if it were financed out of labour income (but this would be $12,500 for LIT, GIT or GITR and $10,000

Table 3: Comparison of savings regimes: economic rents but no uncertainty

	LIT	GIT	GITR	CT
Savings year 0	10,000	10,000	10,000	10,000
Forgone consumption	**10,000**	**10,000**	**10,000**	**8,000**
4% normal rate of return				
Capital income year 1	400	400	400	400
Tax year 1	0	80	0	2,080
Net consumption in year 1	**10,400**	**10,320**	**10,400**	**8,320**
10% rate of return (4% normal return +6% economic rents)				
Capital income year 1	1,000	1,000	1,000	1,000
Tax year 1	0	200	120	2,200
Net consumption year 1	**11,000**	**10,800**	**10,880**	**8,800**
Pre-tax economic rents	**600**	**600**	**600**	**600**
After-tax economic rents	**600**	**480**	**480**	**480**
Tax difference: rents vs no rents	**0**	**120**	**120**	**120**

2.4.20 Results for the case when there are no economic rents and assets generate a 4% normal return follow from our earlier discussion. Net consumption increases by 4% under LIT, GITR and CT, leaving the present value of consumption the same whether earnings are saved or not. However, net consumption only increases by 3.2% under GIT reducing the present value of consumption if income is saved.

2.4.21 When rents are being earned, pre-tax rents are $600. With LIT, these are not taxed so the taxpayer ends up with the full $600. Consumption is higher than it would have been if there were no rents by the full $600 in year 1. By contrast, under GIT, GITR and CT, the government benefits by additional tax of $120. Consumption is only higher than it would have been if there were no rents by $480 in year 1. The taxpayer gains only $480 of the economic rents with the government gaining the remainder.

2.4.22 In conclusion, in terms of capital income taxed:

- LIT would tax neither the normal return nor any economic rents
- GIT would tax the normal return and economic rents at the same rate
- GITR and CT would tax economic rents but not the normal return.

for CT). Suppose instead we assumed $12,500 of labour income in all four cases and the after-tax proceeds had been invested in assets generating a 10% rate of return. With CT there would have been $12,500 of investment on which $750 of pre-tax economic rents would have been generated. The taxpayer would have gained $600 of after-tax economic rents and the government would gain $150 more tax than if the investment had only generated normal returns. Again, the government would be gaining 20% of any pre-tax economic rents. At first sight, it might seem that having a CT makes both the taxpayer and the government better off. But that will not be true once we take account of the fact that there is only a certain amount of investment that is likely to generate economic rents in the first place and whether a country has a CT will not affect the level of investment, which is likely to generate economic rents. This is why it seems best to focus on an example where the same amounts are being invested in all cases.

Treatment of risk

Key conclusions

- With LIT no tax is being imposed on excess returns from risk-taking.
- With a flat rate of tax and full loss offsets, GIT, GITR and CT all involve the government sharing risk with taxpayers, which would not discourage investment in risky activities.
- With progressive marginal tax rates and/or less than full loss offsets, GIT, GITR and CT would all provide some discouragement to investment in risky activities.

2.4.23 The tax treatment of risk is discussed in Analytical Note 1 (Tax treatment of risk and lock-in). Here we are considering taxes imposed on what Auerbach (2009) describes as "excess returns from risk taking". For an asset that generates no economic rents, this is the difference between the actual expected return on these assets and the return on a risk-free asset.

2.4.24 The tax treatment of risk depends in part on which of the four tax bases is being considered. But it also depends on the progressivity of the tax rates applied to the base and on whether taxpayers who make a loss benefit from the full present value of any loss. Under New Zealand's income tax provisions, taxpayers can benefit from the full value of a loss if they have other income against which to offset the loss but not if they do not. If firms do not have other income, losses can be carried forward and used to offset future income but only without interest. Loss restrictions are necessary to reduce the scope for taxpayers to game the tax system but lower the present value of any deductions – and at times deductions will never be able to be utilised – discouraging risk-taking.

2.4.25 We consider two cases separately. First, we consider what happens if there is a flat marginal tax rate and full loss offsets (so any losses that cannot be offset immediately against other income are assumed to be cashed out). Second, we consider what happens if there are progressive marginal tax rates or loss limitations.

2.4.26 With a flat marginal tax rate and no loss limitations, the government would be sharing risk with a taxpayer under a GIT, a GITR or a CT. If, say, there were a 20% marginal tax rate, the government would gain 20% of the premium that is required to compensate taxpayers for risk but at the same time would be bearing 20% of the risk of an investment. The government would be taking a 20% share of both the benefits and costs of taxpayers' investment in risky rather than riskless assets. In this case we can describe these tax bases as **taxing risk neutrally**.

2.4.27 With progressive marginal rates and/or loss limitations, the government would be going beyond the point of just sharing risk. It would be imposing a net burden on taxpayers by taking a greater percentage of the gains than it absorbs in losses. This will tend to discourage investment in risky assets.

2.4.28 New Zealand's GST is a broadly proportional tax on consumption, so its effects are likely to be most like the flat marginal tax rate and no loss limitation case. New

Zealand's personal tax base has progressive marginal rates and loss limitations, so its effects are most like the progressive marginal tax rate/loss limitation case.

2.4.29 In principle, it is attractive for the tax rules to be as neutral as possible between investments with differing risk. It is not generally desirable to tax two people differently on average if both earn the same amount on average, but one person's earning stream is riskier than the other's (for example, one person might earn $1 million each year and the other might make a loss of $1 million half the time and a gain of $3 million the other half).

2.4.30 The discussion above shows that progressive rates create asymmetries in the treatment of risk that can discourage risk-taking. However, as discussed in Chapter 1, governments seek to balance equity and efficiency considerations when determining how progressive the tax system should be. It is likely that governments in the future will want a major tax base that allows for progressive rates to meet their equity goals and will be willing to accept some discouragement to risk-taking to achieve this.

2.4.31 Further, as discussed in Chapter 3, there would appear to be good grounds for taxing economic rents and it does not seem practicable to tax economic rents without, at the same time, taxing excess returns from risk-taking. Therefore, if the government wants to tax economic rents and wants a major tax base that applies progressive marginal rates and/or thinks loss limitations are necessary for integrity reasons, a net burden on risk-taking may be an inevitable consequence. There may, however, be some ways of reducing penalties on risk-taking. For example, the Mirrlees Review suggested that losses might be carried forward with interest.

2.5 Extending analysis to other taxes

RFRM or wealth tax

2.5.1 The effects of other taxes can also be considered within the framework above. For example, the McLeod Review (2001a and 2001b) suggested levying a risk-free return method (RFRM) tax on certain assets when economic income was difficult to tax or not being taxed at present. It suggested that for these assets it might be better to tax an imputed return and otherwise exempt any other income generated by the assets from tax. For example, if the rules were applied to rental property, the aim would be to levy this RFRM tax but no longer tax rental income.

2.5.2 For example, if wealth or net equity of $10,000 was invested, the suggestion was that $10,000 multiplied by a risk-free interest rate be included in a taxpayer's taxable income and taxed at the taxpayer's marginal rate. So, if the risk-free interest rate were 4% and the taxpayer faced a tax rate of 20%, income of $400 would be included as imputed income and this would result in a tax payment of $80.

2.5.3 The effect of an RFRM tax is discussed in Analytical Note 1 (Tax treatment of risk and lock-in). This would tax the normal return like GIT does but would not be equivalent to a tax on labour income, economic rents or the excess returns to risk taking.

2.5.4 In Chapter 6, we discuss a wealth tax (WT). WT is an annual tax on the net wealth of an individual. It is very similar to RFRM tax except that it is levied in addition to an income tax rather than in lieu of an income tax. Suppose in the example above, that there is WT of 0.8% and this is levied with a one-year lag. The WT liability on wealth of $10,000 would be $80, which achieves the same thing as taxing the normal rate of return at 20%. A WT of 1.6% would be equivalent to taxing the normal rate of return at 40%.

2.5.5 Just like an RFRM tax, under a WT, the amount of tax due would be the same even if someone earned an above-normal return. Suppose someone with wealth of $10,000 generates a 10% return of $1,000 (being a 4% normal return and 6% economic rent). Under a GIT with a 20% rate, $200 of tax would be paid. However, under the 0.8% WT, the tax owing is still $80. This suggests that a tax on wealth is equivalent to a tax on capital income that exempts the above-normal return. In other words, a WT does not tax the risky return or economic rents.

Dual income tax

2.5.6 A dual income tax (DIT) has the distinctive features of applying different rates to different types of income, while maintaining the same broad tax base as a GIT. It taxes normal returns to capital at a lower flat rate than it taxes labour income and economic rents.

2.5.7 Under the Norwegian DIT, normal returns are taxed at a low flat marginal rate of tax while labour income and economic rents are taxed at higher progressive marginal rates. The lowest marginal tax rate on labour income and economic rents is aligned with the tax rate on normal returns (often referred to as the tax rate on capital income). In Norway this is 22%.

2.5.8 If something similar was done in New Zealand, this could involve levying a lower tax rate on normal returns while continuing with higher progressive tax rates on labour income and economic rents.[23]

2.5.9 Norway's DIT provides an approach to determining the amount of income considered the normal return to capital that does not require the tax administration or taxpayers to determine whether a particular return is from "labour" or "capital". It does this by calculating the normal return component of income based on a deemed risk-free rate applied to capital assets (for company income, taxpayers then have a risk-free shield based on this amount).

2.5.10 For example, for a businessperson with business assets of $500,000 and income of $100,000, the tax calculation might be as follows. Suppose the normal rate of return is 4%. A normal rate of return on that amount of capital would be $20,000. As a result, $20,000 of the income would be taxed as capital income (or normal returns) at the

[23] If the Norwegian model were copied, the capital rate would be matched to the lowest personal rate (currently 10.5% in New Zealand, 22% in Norway). But New Zealand's lowest personal tax rate is a very low tax rate to apply to all normal returns. There would be options to increase that rate and make other changes to the progressivity of spending or the wider tax settings or design a system that could accommodate a higher rate than the lowest personal rate.

capital income tax rate. If this is assumed to be 10.5%, this will lead to a capital income tax liability of $2,100 (10.5% × $20,000).

2.5.11 The rest of the income ($80,000 in the example above) would be taxed at the progressive marginal tax rates applying to both labour income and economic rents, recognising that much of a business owner's income stems from their personal labour and entrepreneurial skill rather than from passive returns on capital.

2.5.12 Excess returns including excess returns to risk-taking would be levied at progressive marginal rates. Progressive marginal tax rates as well as any loss-limitation provisions would lead to this being a non-neutral tax on risk-taking, which will discourage risk-taking to some extent.

2.5.13 This tax ends up being a TTE tax system except that normal returns are being taxed at the capital income tax rate and economic rents and excess returns to risk-taking are being taxed at the progressive marginal rates that apply to labour income. Chapter 4 considers whether a DIT has practical benefits over a GIT in managing rate differentials between entity and personal rates.

2.6 Conclusion

2.6.1 Table 4 summarises the effects of our idealised tax bases if there is a flat marginal tax rate and full loss offsets. Ticks indicate that the type of income considered is taxed and crosses indicate that it is not taxed.

2.6.2 LIT, GIT, DIT, GITR and CT all tax labour income equivalently but differ in the way they tax capital income. WT is not equivalent to a tax on labour income.

Table 4: Effect of different possible tax bases on taxation of labour and capital income with flat marginal tax rate and full loss offsets

	LIT	GIT/DIT	GITR	CT	WT
Labour income	✓	✓	✓	✓	×
Capital income					
Normal returns	×	✓	×	×	✓
Economic rents	×	✓	✓	✓	×
Risk sharing ("rs")	×	rs	rs	rs	×
Lump sum tax on existing wealth	×	×	×	?	×

2.6.3 A key difference between the tax bases is the taxation of the normal return. GIT (or DIT) taxes normal returns whereas LIT, GITR and CT do not. DIT taxes normal returns at a lower rate than other income while a GIT taxes all income at the same rate. GIT, DIT, GITR and CT all tax economic rents, whereas LIT does not.

2.6.4 The final row notes that if a CT applies to existing wealth, the introduction of a CT or an increase in its rate will involve an element of a lump-sum tax on some forms of existing wealth. We indicate this variation with a question mark. As we have noted, under New Zealand's GST, wealth held in housing or other real durable assets is likely to be shielded from any such lump-sum tax on wealth.

2.6.5 When considering risk, "rs" indicates when the government is sharing risk with the taxpayer. With a flat marginal rate and full loss offset, GIT, DIT, GITR and CT all involve the government sharing risk with taxpayers. However, if there are progressive marginal rates and/or if loss offsets are only partial, as with New Zealand's income tax, the government will be taxing a greater share of gains over and above the risk-free rate than the share of losses, which it absorbs. As a result of taxing excess returns from risk-taking, the government will be imposing a burdensome tax on risk rather than merely sharing risk. Note that despite DIT levying a flat rate of tax on normal returns, it will still create a burdensome tax on risk if there are progressive marginal tax rates on labour income and economic rents or if loss offsets are partial. This is because excess returns to risk-taking are taxed at the same rates as economic rents.

2.6.6 If WT is levied in addition to GIT, this will be equivalent to an additional tax on normal returns. RFRM tax is also a tax on normal returns but could be levied as a replacement for taxation of normal returns through GIT in certain circumstances. Neither WT nor RFRM tax economic rents.

2.6.7 This analysis allows us to draw some insights about how tax bases can be combined into an overall tax system:

- If the government wants to tax normal returns, GIT or DIT can achieve this.
- If the government wishes to tax labour income and economic rents at a higher rate than normal returns, a combination of GIT or DIT with either CT or GITR could achieve this.
- If the government wishes to increase tax on normal returns, levying a WT could do this.
- An RFRM could replace the taxation of normal returns through a GIT but would not tax economic rents.
- GIT combined with LIT would tax labour income at a higher rate than the normal return and economic rents.
- Either imposing LIT or increasing the CT rate would increase taxes on labour income. However, increasing the CT rate would also impose a tax on economic rents and a lump-sum tax on some forms of existing wealth.
- GITR and CT have similar economic properties and consequently overlap to a large degree.

Chapter 3 – Taxes on labour and capital income

Overview

Labour and capital income are the core factors taxed in OECD tax systems. Both labour and capital income (normal returns and economic rents) are taxed under an income tax. A consumption tax is equivalent to a tax on labour income and economic rents.

Most tax systems rely heavily on labour income to gather sufficient tax revenue. Taxing labour income also allows the tax system to be aligned with ability to pay. Therefore, any feasible tax system for the future must include substantial taxation of labour income or its equivalent. A tax system based on ability to pay would tax economic rents at similar rates to labour income.

There is considerable debate as to the taxation of the normal return to capital of domestic residents. Many economists have argued against taxing normal returns; however, recent work has cast doubt on the robustness of this conclusion. Importantly, substantially reducing taxes on normal returns would narrow the tax base at a time of rising fiscal pressures and provide a windfall gain to those who are currently wealthy. This makes arguments to remove or substantially reduce taxes on normal returns weak in the context of rising fiscal pressures.

We consider that the balance of economic opinion is now towards levying some tax on the normal returns to capital of domestic residents but possibly at a lower rate than tax on economic rents and labour income.

A separate issue is the taxation of the capital income of non-residents on their investments into New Zealand. As much of the impost of taxation of non-resident capital income is likely to be passed onto domestic factors, there are economic efficiency reasons not to tax this income too highly.

Inland Revenue considers that an income tax (general or dual) and a consumption tax provide an appropriate paradigm for main bases for New Zealand going forward. This combination results in a system where labour income and economic rents are taxed at the same rate. Having both an income tax and a consumption tax allows normal returns to be taxed at a lower rate than would be the case if there was only an income tax (for the same revenue level).

There will, however, be inevitable distortions from taxing normal returns under an income tax due to practical difficulties with taxing capital income and inflation. Both the practical and economic concerns give weight to the argument that increasing consumption taxes would be a more efficient way to increase revenue should that be required in the future.

Assuming New Zealand continues with the main bases of income tax and consumption tax going forward, Part 2 looks at possible improvements to New Zealand's income and consumption tax. This includes looking at the pros and cons of a general versus dual income tax. Part 2 also looks at the pros and cons of adding alternative bases to this mix of bases.

3.1 Scope of chapter

3.1.1 Chapter 2 discussed how different tax bases could be distinguished by how they tax the underlying economic factors of labour income, existing wealth and different forms of capital income. New Zealand's two main bases of income tax and GST result in a system that ultimately relies heavily on the taxation of labour income, with the labour income component of income tax together with GST accounting for over two-thirds of core Crown revenue.

3.1.2 This chapter discusses the pros and cons of taxing labour income and different types of capital income (normal returns and economic rents) and whether they should be taxed at the same or different rates. This can be used to draw insights into the pros and cons of different tax mixes. This chapter focuses on main bases and Chapter 6 discusses alternative bases.

3.1.3 This chapter concludes that a combination of an income and consumption tax remains an appropriate basic paradigm for the main tax bases for New Zealand going forward because it:

- preserves the ability to tax different income types at different rates
- allows governments to balance equity and efficiency concerns, and
- provides a stable foundation that is flexible to changing circumstances.

3.1.4 Given this, Part 2 proceeds on the basis that New Zealand continues with the main bases of an income tax and a consumption tax.

3.1.5 This chapter proceeds as follows. Section 3.2 discusses the chapter motivation. Section 3.3 discusses the rationale for labour income taxation. Section 3.4 discusses the theoretical framework for the taxation of capital income. Section 3.5 discusses practical considerations with taxing capital income under different tax bases. Section 3.6 discusses implications for the design of the tax system. Section 3.7 concludes.

3.2 Motivation

3.2.1 The purpose of this chapter is to assess whether labour and capital income should be taxed at the same or different rates and if there are any insights that can be drawn from the literature as to the desirable tax mix.

3.2.2 The reason we are undertaking this assessment is because there is a particular controversy in the literature over the extent to which the normal returns to capital of domestic residents should be taxed. For many years, a conventional wisdom among economists held that there was a strong "in-principle" case against taxing normal returns to capital at least in the long run. More recent research has challenged this conclusion, casting doubt on its robustness. This chapter provides a survey of arguments both for and against taxing normal returns, noting that the economic literature remains complex and inconclusive.

3.2.3 A separate practical argument against heavily taxing normal returns stems from the difficulties of taxing capital income comprehensively and the economic distortions this creates. The Mirrlees Review in the UK suggested that the UK should no longer tax normal returns primarily for this reason.

3.2.4 This chapter can provide insights into the appropriate tax mix both at current revenue levels and at higher revenue levels. However, this assessment needs to take account of transition issues, namely:

- At current revenue levels, reducing taxes on normal returns from the status quo would necessitate replacement revenue, typically through higher taxes on labour income. This would likely mean lower taxes on those who are currently wealthy and higher taxes on future labour income earners who are often less well off – raising equity concerns.
- These equity considerations become even more pressing if governments need to raise taxes to address growing fiscal pressures. Reducing taxes on normal returns at this point in time might mean labour income earners face a double burden: first to make up for revenue forgone through lower capital taxation, and second to address the broader fiscal challenges. Further, reducing taxes on normal returns would reduce a tax base at a time of growing fiscal pressure. This weakens arguments for *reducing* taxes on normal returns.
- However, both the economic and practical concerns with taxing normal returns give weight to the argument that increases in consumption taxes may be a more efficient way to raise *additional* tax revenue should that be required. Chapter 5 considers how increases in consumption taxes could also be designed to meet distributional goals.

3.2.5 The next two sections consider current literature on the desirability of taxing labour and capital income.

3.3 Rationale for labour income taxation

3.3.1 Chapter 2 showed that all main tax bases discussed in that chapter either taxed labour income or did something equivalent, but they differed in the way that they taxed capital income. We see three main reasons that labour income will remain an important base going forward:

- revenue sufficiency
- aligning the tax system with ability to pay, and
- meeting progressivity objectives.

Revenue sufficiency

3.3.2 Labour income taxation is necessary for revenue sufficiency. It provides a stable, reliable tax base with relatively broad coverage and limited opportunities for international shifting. Any feasible tax system must include substantial taxation of labour income or its equivalent.

3.3.3 Labour income comprises the largest part of New Zealand's direct income tax base and is economically taxed under GST as well. As shown in Table 5, over 60% of direct income tax (and consequently over 40% of core Crown revenue) comes from taxes on labour income through source deductions. GST constitutes another 25% of core Crown (consolidated) revenue and functions largely as a tax on labour income. Together, these sources represent over two-thirds of core Crown revenue.[24]

Table 5: New Zealand's direct income tax base (revenue) for year ended June 2023

	$m	Percentage	Form of income
Individuals			
Source deductions	47,386	61.5%	LI
Other persons	9,904	12.8%	LI/KI
Refunds	-2,182	-2.8%	LI/KI
Fringe benefit tax	769	1.0%	LI
Total individuals	**55,877**	72.5%	
Corporate tax			
Gross company tax	18,327	23.8%	LI/KI/NRKI
Refunds	-970	-1.3%	LI/KI/NRKI
Non-resident withholding tax	621	0.8%	NRKI
Total corporate tax	**17,978**	23.3%	
Other direct income tax			
RWT on interest	2,092	2.7%	KI
RWT on dividends	1,127	1.5%	KI/LI
Total other direct income tax	**3,219**	4.2%	
Total direct income tax	**77,074**	100.0%	

Ability to pay principle

3.3.4 A key reason for taxing labour income, and for requiring those with higher labour income to pay more tax, is that labour income serves as an important indicator of ability to pay. Other things being equal, if employee A earns $500,000 per year and employee B earns $50,000 per year, A has a greater capacity to pay than B.

3.3.5 There is widespread acceptance that those with greater opportunities and greater ability to pay should contribute more to public finances. Revenue sufficiency also dictates that taxes increase with income because levying tax at a level everyone can afford would not generate sufficient revenue.

Progressivity goals

3.3.6 Successive New Zealand Governments have used personal income tax as the primary instrument to achieve progressivity objectives. Through progressive marginal tax rates, those with higher taxable incomes contribute a higher proportion of their income in tax

[24] In Table 5, LI = labour income tax, KI= capital income tax and NRKI = tax on the income of non-residents. Data is from the Budget Economic and Fiscal Update 2024, Notes to the Forecast Financial Statements: Note 1: Sovereign Revenue (Accrual) (The Treasury, 2024).

than those with lower incomes. Most OECD countries have progressive personal tax systems.

3.3.7 The Treasury's fiscal incidence analysis (see Figure 4) shows that progressive personal income tax is the main mechanism by which higher-income households contribute more to financing public spending than lower-income households. It is likely that future governments will continue to want a major tax base that allows for progressive taxation, making personal income tax an important component of the tax system for the foreseeable future.

3.4 Capital income taxation: Theoretical framework

3.4.1 Note that when we are referring to capital income in this chapter, we are referring to the capital income of domestic resident individuals.

3.4.2 New Zealand also levies tax on the capital incomes of non-residents who invest into New Zealand. Taxing the capital income of non-residents too highly can be costly for New Zealand. This is because high capital income taxes on inbound investment have the potential to raise the required return on investment that New Zealand businesses must generate. This can reduce capital investment into New Zealand thereby reducing labour productivity and lowering wages and shifting the incidence of the tax onto domestic factors. Inland Revenue's 2022 LTIB documented that New Zealand had relatively high effective marginal tax rates (EMTRs) on inbound investment (the EMTR is the proportion of the real pre-tax rate of return on a marginal investment that is lost in tax). Issues regarding the taxation of non-resident investment and implications for the income tax are explored further in Chapter 4.

Arguments against taxing normal returns

3.4.3 A key concern with taxing normal returns on capital income (such as interest on a safe savings account) is that it can discourage savings.[25] Taxing this income effectively imposes an additional consumption tax on those who defer consumption, with the rate increasing the longer savings accumulate before being spent.

3.4.4 Table 6 illustrates this effect. Consider a taxpayer who saves $1,000 in an account earning 4% annual interest (being the normal return). Without tax, after 20 years they could consume $2,191. With a 33% tax on capital income, they could only consume

[25] The effects of taxes on savings will reflect both an income and a substitution effect. The substitution effect is that taxes can lower the after-tax return from saving. Other things being equal, this will cause people to choose to consume more immediately and less in the future. At the same time, the tax will make people poorer. With the tax in place, people will have reduced overall levels of consumption through time to pay the tax. Excess burdens of tax arise because of substitution effects not income effects. When we say that a tax on capital income discourages saving, we mean that it has a distorting substitution effect that discourages saving and that the cost of the tax to taxpayers is greater than it would have been if the same present value of revenue had been raised in a non-distorting way. Whether a tax on capital income lowers the overall level of savings is uncertain because income and substitution effects can have opposing effects on savings. However, irrespective of the income effect, the tax will be distorting because current consumption will be higher and saving lower than if the same amount of revenue was raised in a way that did not distort savings decisions.

$1,697, $494 less. This is equivalent to a 22.54% tax on consumption delayed for 20 years. After 50 years, this implicit consumption tax rises to 47.20%.

Table 6: Taxes on capital income and equivalising consumption tax

Year in which savings are spent	Consumption if no tax	Consumption with 33% income tax	Equivalising rate of CT
0	1000	1000	0.00%
1	1040	1027	1.27%
2	1082	1054	2.52%
5	1217	1141	6.19%
10	1480	1303	11.99%
20	2191	1697	22.54%
30	3243	2211	31.83%
40	4801	2880	40.01%
50	7107	3752	47.20%
100	50505	14079	72.12%

3.4.5 This non-neutral treatment means those who defer consumption face higher effective tax rates than those who consume immediately. If two people earn the same labour income, pay tax on it, and have $1,000 remaining, the person who spends immediately faces no further tax, while the saver faces additional taxation equivalent to an increasing consumption tax rate over time. The Mirrlees Review argues this appears to be a non-neutral tax on patience.

3.4.6 Two main streams of literature have supported the proposition that normal returns should not be taxed on this ground:

- Atkinson and Stiglitz (1976) questioned whether governments concerned with distributional issues should impose different tax rates on different consumption goods, including consumption in different time periods. Under certain assumptions about preferences, they found different consumption tax rates to be undesirable.
- Chamley (1986) and Judd (1985) modelled taxpayers as living for an infinite period, with implicit taxes on consumption growing larger over time. They argued that there should be no taxes on normal returns in the very long run, although their models actually support high taxes on capital income in the short run.

3.4.7 However, as Banks and Diamond (2008) argue, neither stream of literature provides a robust case against any taxation of normal returns, and recent studies have strengthened the case for some level of taxation.

3.4.8 It is important to note that taxpayers may often be paying tax on both the inflationary and the real component of capital income and this can mean a very high tax rate on the real component of income. For example, suppose that when the nominal interest rate is 4% per year, inflation is 2% per year. A tax rate of 33% on nominal interest income would mean a tax rate of 66% on real interest income because half of the nominal return that is being taxed is merely compensating for inflation. The tax bias discouraging savings will be considerably higher than would be the case if only real capital income were being taxed. This point is discussed more later.

Arguments for taxing normal returns

3.4.9 The simple argument for some taxation of normal returns relates to transition. While Chamley and Judd argued against compounding taxes on normal returns forever, this does not justify immediately removing existing capital income taxes. Doing so would provide a windfall to current wealth holders while requiring increased taxes on others to maintain revenue. This would be unattractive on both fairness and efficiency grounds, especially if fiscal pressures are already increasing tax burdens elsewhere.

3.4.10 Recent economic research has identified several additional arguments for taxing normal returns:[26]

- Skill level correlation: Those with greater skill levels tend to be more patient and save more. Saez (2002) argues that taxing capital income can therefore serve as an indirect way of taxing those with greater ability to pay.
- Incomplete markets and borrowing constraints: Aiyagari (1995) showed that with economic shocks and borrowing constraints, capital income taxation can help relieve the severity of these constraints by lowering taxes in other periods.
- Life cycle effects: Erosa and Gervais (2002) found that optimal taxation in a life cycle model supports significant capital income tax rates. Conesa, Kitao, and Krueger (2009) developed a simulation model showing that capital income might optimally be taxed at rates even higher than labour income.
- Human capital investment: Jacobs and Bovenberg (2010) explored how capital income taxation can reduce distortions between financial investments and investments in human capital, especially when not all costs of human capital investment can be immediately deducted.
- Direct welfare effects of wealth: Saez and Stantcheva (2018) provide a model where wealth directly affects welfare beyond just enabling future consumption, estimating that substantial positive tax rates on capital income would be optimal.

3.4.11 The transition issue alone provides a strong case for continuing some taxation of normal returns. Removing such taxes would create a windfall for the wealthy while increasing tax burdens on others. While the economic literature suggests various reasons for taxing normal returns, there is no clear consensus on how heavily they should be taxed relative to labour income. The weight of opinion appears to favour some taxation, but likely at lower rates than labour income.[27,28]

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[26] Fuller discussions are in Banks and Diamond (2008), Bastani and Waldenström (2020) and Scheuer and Slemrod (2021).

[27] Before continuing, it is worthwhile dismissing one false argument that has sometimes been used in favour of taxing capital income. This is that taxing both labour and capital income allows lower taxes on labour income, which *will tend to reduce work disincentives, and so taxing both capital and labour income will tend to make taxes on labour income less distorting*. While it is true that taxing both capital and labour incomes allows tax rates on labour income to be lower, this does not necessarily mean that this would improve incentives to work. If someone is working to finance future consumption, taxes on savings will discourage work effort in much the same way as taxes on labour income.

[28] In a recent paper Straub and Werning (2020) challenge some of the conclusions that have been drawn from Chamley and Judd's work. Scheuer and Slemrod (2021) argue that this and other papers have overturned the conventional wisdom that there should be no taxes on capital income.

3.4.12 This uncertainty suggests that a tax system should allow governments flexibility to tax normal returns without necessarily requiring the same rates as labour income.

Taxation of excess returns

3.4.13 There are strong grounds for taxing economic rents at substantial rates. The Mirrlees Review argued for taxing excess returns (economic rents and risk premiums) at the same rates as labour income while exempting normal returns.

3.4.14 Taxing economic rents at the same rate as labour income would align taxation with ability to pay. Further, in many cases, particularly for the self-employed, it is often impractical to determine whether higher returns represent economic rents or labour income.

3.4.15 Several studies provide additional support for taxing excess returns at substantial rates:

- Heterogeneous returns: Gerritsen, Jacobs, Spiritus & Rusu (2025) examine optimal taxation when people systematically differ in their returns on capital, either due to ability differences or scale effects in wealth management. In both cases, positive capital income taxes are optimal.
- Income shifting concerns: Christiansen and Tuomala (2008) demonstrate that when individuals can shift income between labour and capital, there is a case for taxing capital income to preserve the integrity of the labour income tax base. In New Zealand this might be relevant to, for example, incentives for owners of closely held businesses to pay themselves a salary versus retaining earnings.
- Social insurance: Varian (1980) noted that capital income taxation can provide social insurance unavailable in the market. Jacobs and Schindler (2012) argue that capital income taxes play an important role in optimal social insurance, particularly for risks that cannot be easily insured privately.

3.4.16 A potential argument against heavily taxing excess returns is that, with progressive tax rates or limitations on loss offsets, taxing excess returns can discourage risk-taking. As noted in Chapter 2, a penalty on risk-taking is an efficiency costs that arises from implementing a progressive tax system based on equity grounds.

3.4.17 The overall conclusion is that there is a strong in-principle case for taxing economic rents and returns to risk-taking, although implementation through an income tax with progressive rates and loss limitations will inevitably discourage some risk-taking.

3.4.18 Stiglitz was one of the co-authors of the Atkinson and Stiglitz (1976) paper that, as noted above, has been used in support of the proposition that normal returns should not be taxed. Stiglitz (2018) recently clarified that "even within the confines of a model in which differences in labor productivity are the only source of differences in income, the conclusion that there should be no capital taxation is in general wrong". He further noted that "The real argument behind the taxation of capital is almost surely related to disparities in inherited capital and in the ability to earn returns out of capital — and in luck". These considerations provide grounds for taxing both normal returns and excess returns.

3.5 Practical issues with taxing capital income

3.5.1 Different tax bases will give rise to different practical issues in terms of their effectiveness in taxing different elements of capital income. Here we discuss practical issues with four tax bases that tax elements of capital income (normal returns and/or economic rents) to determine if any of these bases address practical issues better. The bases we consider are:

- general income tax (GIT)
- dual income tax (DIT)
- general income tax with a rate of return deduction (GITR), and
- consumption tax (CT).

3.5.2 The practical issues that we consider are:

- the extent to which it is practically possible to tax the capital income base that is sought to be taxed
- the effect of inflation
- the effect of taxation of the base on risk-taking.

Comprehensiveness of the base

3.5.3 The four tax bases above seek to tax different elements of capital income. As discussed in Chapter 2, the idealised base of a GIT or DIT is a comprehensive tax on economic income. There are, however, two types of economic income that are theoretically in this base but are practically difficult to tax – accrued capital gains and imputed rental income. We discuss issues with taxing these forms of income below.

3.5.4 CT and GITR do not seek to tax full economic income. Under these taxes, the normal return is not taxed but excess returns are.

Capital gains

3.5.5 Accrued capital gains form part of economic income and therefore belong in the idealised base of either a GIT or DIT. The base for GITR also includes accrued capital gains. However, taxing gains on accrual is impractical for most assets because it would require continuous valuation, create volatile tax liabilities, and raise liquidity issues when tax payments come due without corresponding cash flows.

3.5.6 While no OECD country attempts to tax accruing capital gains generally, most do tax realised capital gains. This approach creates its own distortions, particularly "lock-in" effects that discourage efficient asset reallocation. Lock-in affects GIT, but as explained in Analytical Note 1 (Tax treatment of risk and lock-in) does not affect GITR. Chapter 4 discusses how the Norwegian-style DIT removes lock-in for shares held by investors, but lock-in remains for assets owned at the company level or assets held outside of companies. Chapter 4 also discusses implications of realised capital gains taxes for income taxes generally.

3.5.7 An indirect CT automatically captures capital gain when income is spent, so is not affected by lock-in.

Imputed rental income

3.5.8 A second major deviation from economic income under most income taxes is the non-taxation of imputed rental income (the consumption benefit derived from durable assets), primarily owner-occupied housing. This creates a non-neutrality between renters and homeowners with equity in their homes.

3.5.9 Consider two individuals each earning $70,000 salary. Person A owns their home and saves $20,000 in rental costs (after ownership expenses) annually. Person B rents and pays $20,000 more than ownership would cost. Person A receives a $20,000 consumption benefit compared to person B, yet both have identical taxable income of $70,000. As of March 2024, owner-occupied housing and land comprised 45% of gross household wealth in New Zealand, making this non-neutrality significant.

3.5.10 Few countries tax imputed rental income due to political and practical challenges. The McLeod Review Issues Paper suggested using a risk-free return method (RFRM) tax on net equity in owner-occupied and rental housing but noted in their Final Report (McLeod et al, 2001b, p iv) "such widespread opposition that no government is likely to implement it in the near future". Objections included housing's status as a social good, cash flow problems, existing property taxation through rates, and compliance costs.

3.5.11 Under GITR no tax is levied on normal returns so there is no distortion in not taxing imputed rental income from owner-occupied property. Under a CT like New Zealand's GST, imputed rental income is included when someone purchases a house – the GST on the house is a prepaid lump sum of the present value of consumption of the buildings and improvements. Those who purchase a secondhand house are effectively purchasing the (now updated for market-based depreciation) GST-inclusive remaining present value of consumption of the buildings and improvements.

Inflation

3.5.12 Most income taxes apply to nominal rather than inflation-adjusted income. This can result in high tax rates on real economic income, particularly for interest earnings (see paragraph 3.4.8).

3.5.13 The effects of inflation vary across assets with different depreciation rates. Typically, more inflationary gains are taxed for shorter-lived assets than for longer-lived assets, creating biases in investment allocation. While comprehensive inflation indexing could address these issues, it would significantly increase tax system complexity.

3.5.14 By applying lower tax rates to capital income, DIT reduces the taxation of inflationary gains compared to GIT. Combining GIT with CT provides another way to balance this issue. GITR or CT avoids taxing the inflationary component of normal returns entirely.

Risk

3.5.15 As discussed in Chapter 2, income tax systems often treat gains and losses asymmetrically, particularly through progressive marginal rates and limitations on loss offsets. These features of the tax system discourage risk-taking because the government shares more of the gains than losses.

3.5.16 Progressive rates mean the government takes a larger share of successful outcomes than it absorbs of losses, effectively imposing a net tax on risk-taking. Similarly, when losses must be carried forward rather than immediately offset against other income, the time value of money reduces their real value, further discouraging risky investments. These issues affect GIT, DIT, and GITR approaches. A flat-rate value-added tax such as GST, however, does not impose a net burden on risk-taking because it proportionally shares in both gains and losses.

Practical issues conclusion

3.5.17 In summary:

- The idealised bases of GIT, DIT and GITR all include the taxation of capital gains. GIT and DIT are affected by lock-in effects whereas GITR can remove lock-in effects. An indirect CT taxes capital gains when income is spent so is not subject to lock-in effects.
- The idealised bases of GIT and DIT include imputed rents on owner-occupied housing whereas GITR does not. A CT effectively taxes imputed rents.
- An argument for DIT or GITR is that it reduces or removes the taxation of inflationary gains from capital income. To some extent this can be addressed through the tax mix under a GIT/CT system.
- Any one of GIT, DIT or GITR are likely to place a net burden on risk-taking.

3.6 System design considerations

3.6.1 Given the practical difficulties with taxing normal returns comprehensively, the Mirrlees Review concluded that "taxing the return to savings under a standard income tax implies accepting arbitrary distortions to the pattern of saving both over time and across assets". This led them to recommend exempting the normal rate of return entirely through a GITR approach, focusing taxation on excess returns while minimising non-neutralities between different assets.

3.6.2 While the Mirrlees approach has some appeal, it presents challenges in the current context. Completely removing or substantially reducing taxes on normal returns in the current context would eliminate a revenue source at precisely the time when fiscal expenditure pressures are rising. The benefits would disproportionately flow to those with substantial wealth either now or in the future. This would likely require not only higher taxation of other factors to compensate for lost revenue but even higher taxes on these factors if future revenue needs increase further.

3.6.3 Designing a tax system that prevents normal returns from being taxed at all is likely to raise substantial equity concerns and would be unlikely to provide a durable approach

to meeting future governments' distributional objectives. Additionally, systems like GITR also face practical implementation challenges. If the tax base is not taxed comprehensively, for instance, if capital gains remain partially or entirely untaxed, little economic income may be captured from appreciating assets, making it unattractive to further reduce capital income taxes by allowing normal return deductions.

3.6.4 Alternative more targeted approaches to reducing taxes on savings create other problems. For example, targeted exemptions for retirement savings conflict with the fundamental decision to maintain income taxation and create new distortions while retaining others. To the extent there is an argument to keep the tax rate on normal returns low, approaches that do this in a broad-based way will be more neutral.

3.6.5 Despite the non-neutralities inherent in income taxation, income taxes provide a broad base capable of raising substantial revenue progressively. A combination of income and consumption taxes offers a balanced approach:

- Normal returns are taxed at lower rates than would be the case if there was only an income tax as a main base and the same amount of revenue was raised.
- Governments retain flexibility to adjust the tax mix based on changing priorities.
- Some distortions are mitigated without eliminating the ability to tax normal returns.
- Progressive taxation remains feasible across the tax system.

3.6.6 A CT combined with a GIT reduces overall income tax distortions without abandoning taxation of normal returns. A DIT coupled with a CT further reduces distortions while maintaining a progressive system. Either of these combinations provides reasonable flexibility while acknowledging the inherent limitations of any tax system.

3.7 Conclusion

3.7.1 This chapter showed that the economics literature does not provide definitive conclusions as to the relative extent to which the tax system should tax normal returns to capital versus labour income and economic rents. However, we considered that based on theoretical grounds the balance of opinion is towards some taxation of normal returns but potentially at lower rates than labour income and economic rents.

3.7.2 While there are practical arguments against comprehensive taxes on income that seek to tax the normal return, there are competing considerations. Removing taxes on normal returns would remove a source of revenue when New Zealand has rising pressure on revenue and would benefit those with wealth. Inland Revenue considers a durable tax system needs to have the flexibility to tax normal returns thereby allowing governments to balance equity and efficiency concerns.

3.7.3 Given these issues, Inland Revenue considers that an income tax and a consumption tax provide an appropriate paradigm for main bases for New Zealand going forward. Part 2 proceeds on this basis.

Part 2: New Zealand's tax system

Part 2: Introduction

In Part 1 we concluded that the overall tax system should tax both the labour income and capital income of domestic residents to some degree. However, there are arguments for ensuring that the taxation of the normal return to residents' capital income (savings) is not too high. Further, there are good reasons in principle to tax economic rents of domestic residents at similar rates to labour income. There are also economic costs from taxing non-resident investment too highly.

Two possible combinations of main tax bases that could achieve this goal are a general income tax and a consumption tax or a dual income tax and a consumption tax. Under these combinations, labour income and economic rents are taxed at the same rate and normal returns are taxed at a lower rate than if there was only an income tax base. Either system can also be designed to be progressive overall, particularly when considered jointly with the transfer system. Either system allows for governments to balance equity and efficiency goals over time. Therefore, this Part proceeds on the basis that New Zealand continues with an income tax (general or dual) and a consumption tax as its main bases.

This Part focuses on possible modifications or improvements to New Zealand's tax system. It begins by discussing New Zealand's current main bases: income tax in Chapter 4 and consumption tax in Chapter 5. The focus is on options to make these bases more flexible to changing revenue needs to make the system more sustainable in the face of long-term fiscal pressures.

Chapter 6 discusses if it would make sense to add any other, generally smaller, bases (other than the current excise taxes) to this tax mix. Alternative bases would be justified at current revenue levels if they had desirable efficiency or fairness properties but could also be an approach to meet increasing revenue needs if that occurred. However, as we discussed in the Overview, we would see adding new bases as a less flexible way to adjust to changing revenue needs than being able to change rates on main bases in a way that supported efficiency and equity goals.

But first, we start here with an overview of New Zealand's current tax system. The Environmental Scan provided a more in-depth analysis of New Zealand's tax system and how it compares to other OECD countries.

New Zealand's tax system

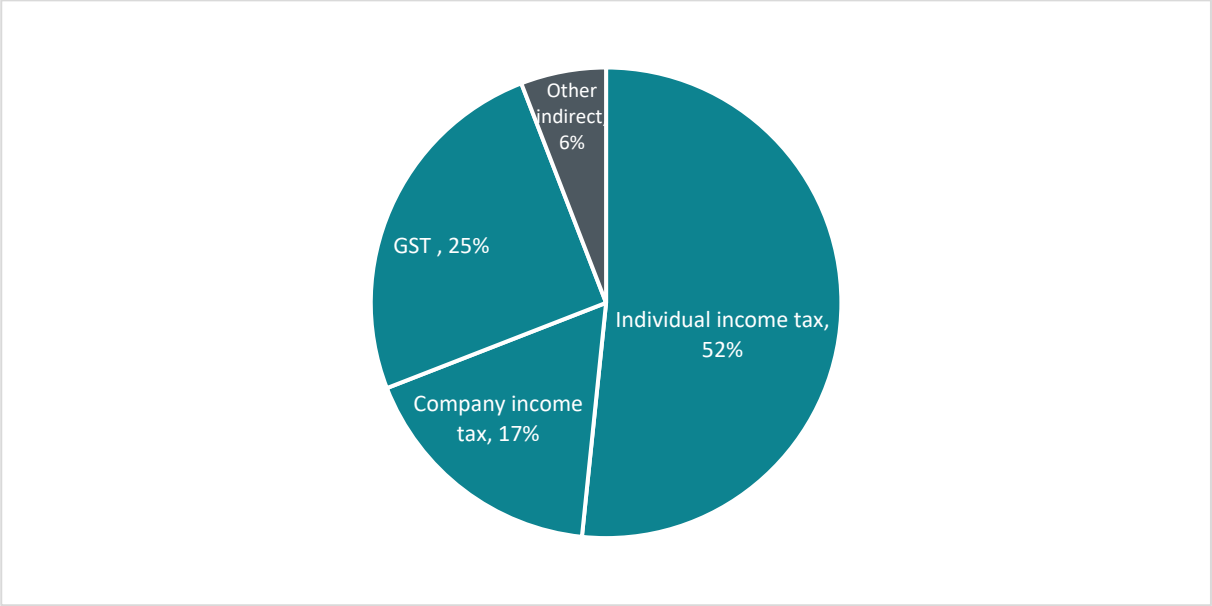
In New Zealand, income tax and GST raise over 90% of core Crown tax revenue on a consolidated basis (that is, removing tax the government pays). This section on New Zealand's tax system focuses on the central government tax base (core Crown consolidated revenue).

Figure 5 shows that income tax forms most of the central government tax base, generating around 70% of core Crown tax revenue. This is comprised of income tax on individuals (52%)[29] and income tax on companies (17%).[30] The GST base is about half the size of the individual income tax base; constituting around 25% of consolidated core Crown tax revenue.

[29] This includes trust and Māori authority income.

[30] Company tax here includes tax paid by PIEs, which constitutes around 8% of net company tax.

Figure 5: Sources of revenue as a percent of core Crown tax revenue, 2023



Source: The Treasury (2024b)

The income tax base consists of multiple regimes (see Table 8):

- personal (or individual) tax regime
- company tax regime
- trust regime
- portfolio investment entity (PIE) regime, and
- Māori authority regime.

The personal tax regime provides for progressive marginal tax rates. Table 7 sets out the personal tax scale applying from 31 July 2024.

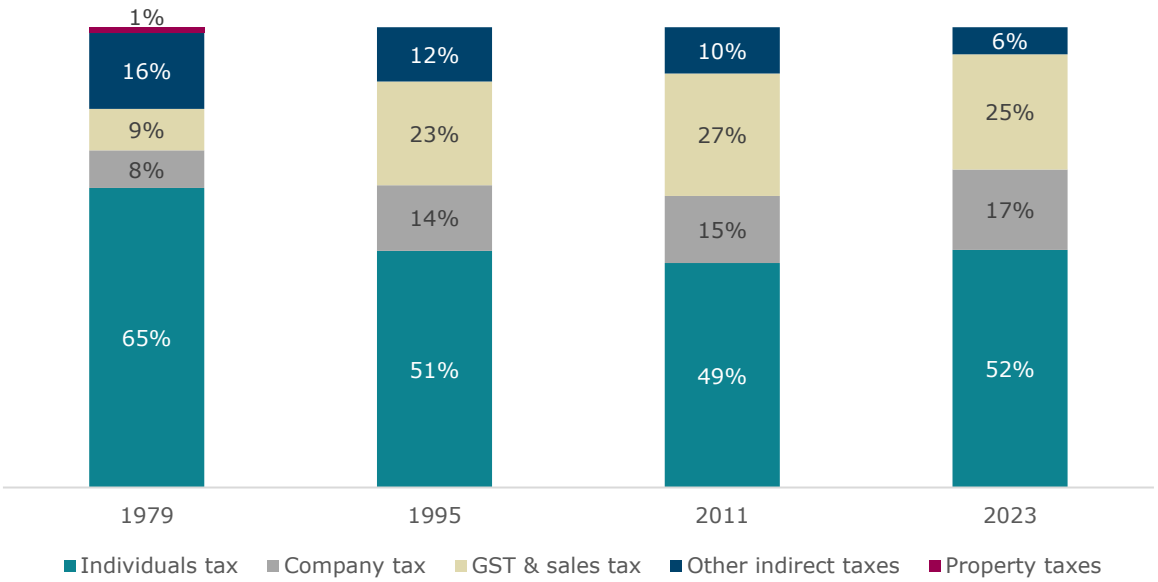
Table 7: Income tax scale

From 31 July 2024	Statutory tax rate
$1–$15,600	10.5%
$15,601–$53,500	17.5%
$53,501–$78,100	30%
$78,101–$180,000	33%
Over $180,000	39%

New Zealand's GST, a value-added tax, was implemented in 1986, replacing various sales taxes as part of reforms to reduce the economic costs and improve the equity of taxation. GST was initially implemented at 10%, then increased to 12.5% in 1989 and to its current rate of 15% in 2010.

The proportion of revenue raised by the central government from general consumption taxes (sales tax and GST) has consequently increased from 9% of revenue in 1979 to 25% in 2023.

Figure 6: Sources of revenue as a percent of central government tax revenue



Source: Statistics New Zealand and The Treasury (2024b)

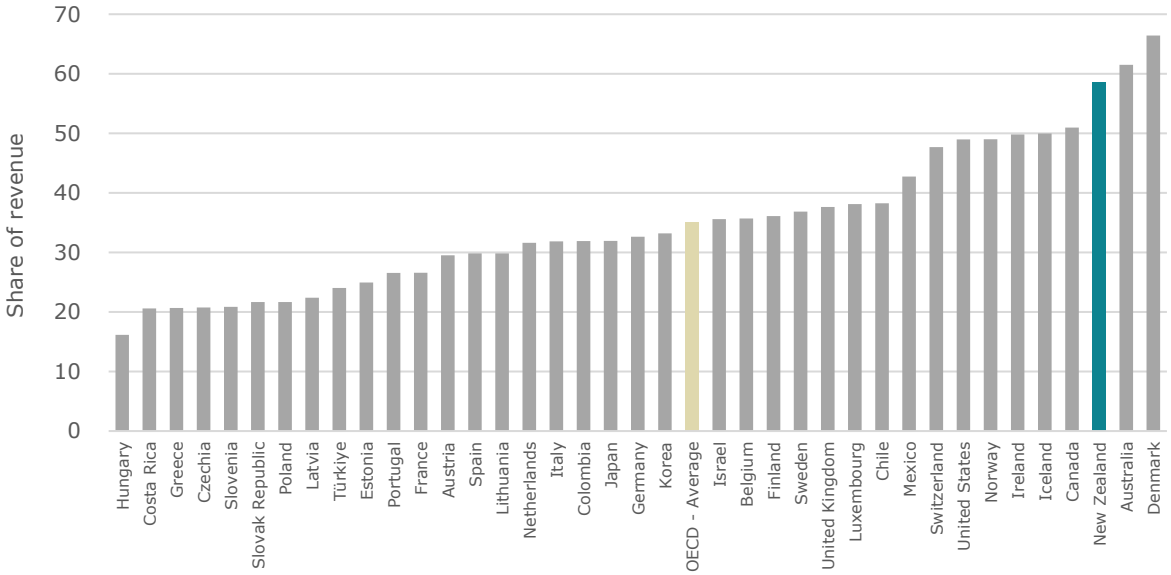
New Zealand's tax system compared to other OECD countries

To enable comparability, New Zealand's tax system is compared to other OECD countries here at the general government level. This means the comparison includes taxes levied at all levels of government. For New Zealand, the general government level includes local government and therefore local government rates.

New Zealand relies on general income tax more than most OECD countries. Figure 7 shows income tax from individuals and companies for OECD countries as a percent of general government revenue.

General income taxes vary from 16% of general government tax revenue in Hungary to 66% of tax revenue in Denmark, with both New Zealand and Australia gathering a relatively high proportion of revenue from general income taxes at 59% and 62% of general government revenue respectively (this is lower than the number reported in Figure 5 due to the inclusion of local government rates in tax revenue). On average, OECD countries gather 35% of tax revenue from general income taxes.

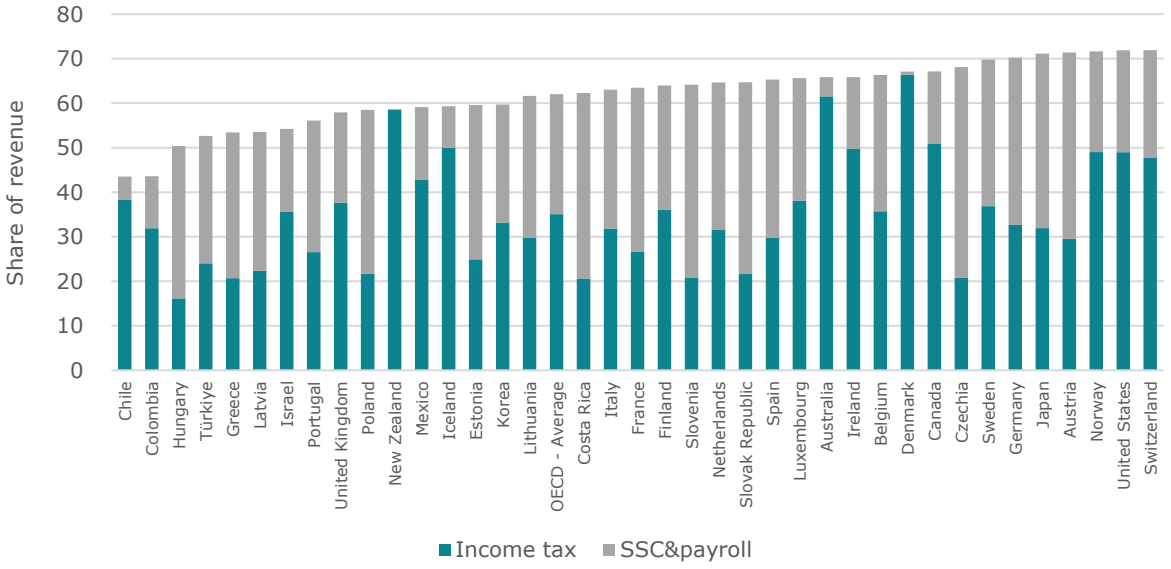
Figure 7: Income tax as a percent of general government revenue, 2021



Source: OECD (2024)

New Zealand raises a greater proportion of revenue from general income taxes because most other OECD countries have a payroll tax or significant social security contribution (SSC) tax as part of their tax mix. Figure 8 shows that when taking general income tax (on individuals and companies), SSCs and payroll taxes together, New Zealand's share of revenue from these taxes is close to the OECD average (Figure 8 excludes ACC for New Zealand).

Figure 8: Income tax, SSC and payroll tax as percent of general government revenue, 2021



Source: OECD (2024)

Taking these taxes as a share of GDP, New Zealand is also close to the OECD average, at 20.2% of GDP for New Zealand (or 21.2% including ACC) versus 21.4% of GDP for the OECD average (see Figure 12 Environmental Scan).

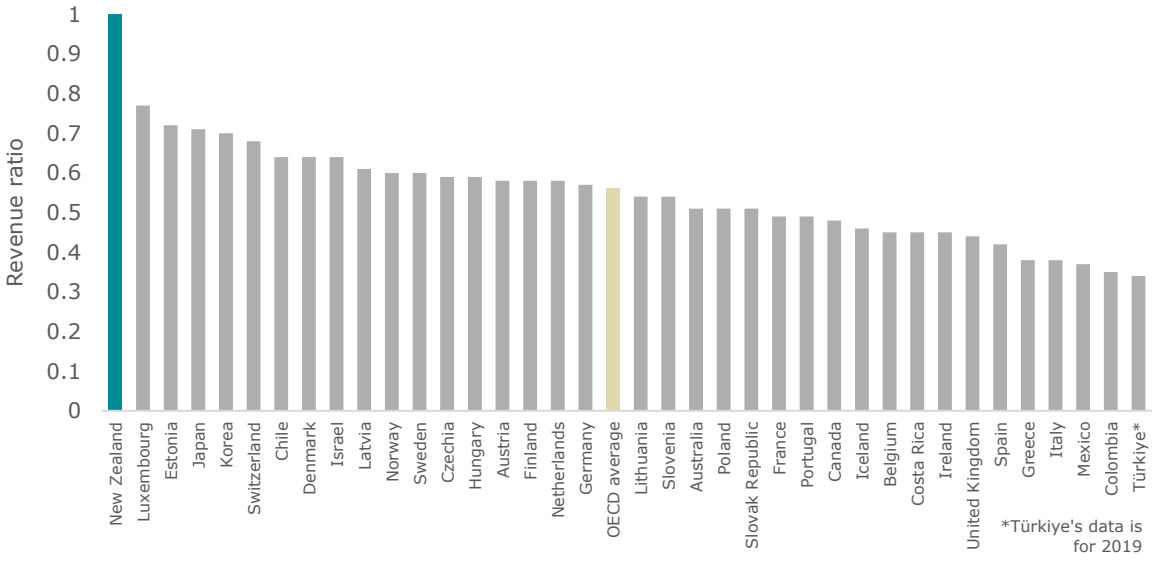
As discussed in the Environmental Scan, there are comparability issues when comparing how much revenue New Zealand raises from GST when compared to other countries' general consumption taxes. This is because New Zealand is unusual in charging GST on public services, which does not generate net government revenue. Adjusting for this, we calculated GST results in New Zealand raising around 1.7 percentage points of GDP more than the OECD average from general consumption taxes – at 8.9% versus 7.2% of GDP (Environmental Scan paragraph 82).[31]

However, New Zealand makes less use of specific consumption taxes than the average OECD country. Every OECD country levies some form of non-general tax on goods and services. Figure 10 shows that revenue from these taxes was 3.6% of GDP on average across the OECD in 2021, versus 2.3% of GDP in New Zealand. Putting general and specific consumption taxes together makes New Zealand's overall level of consumption taxation compared to GDP about 0.5% of GDP higher than the OECD average according to our calculations (see Figure 11).

Unlike many other countries, New Zealand has a single rate of GST on almost all supplies and does not have exemptions from the GST base for necessities or social goods. Rather, exemptions from New Zealand's GST are based on practical considerations with hard to tax items excluded from the base.

Consequently, New Zealand has the broadest GST base in the OECD. The OECD measures the comprehensiveness of the GST base through the VAT revenue ratio (VRR). The VRR measures the difference between actual revenue and the revenue that would be collected if VAT was applied at a country's standard rate to all final consumption expenditure.[32] As shown in Figure 9, the OECD finds that New Zealand has the highest VAT revenue ratio (VRR) out of the OECD countries it reviewed.

Figure 9: VAT revenue ratio, 2020



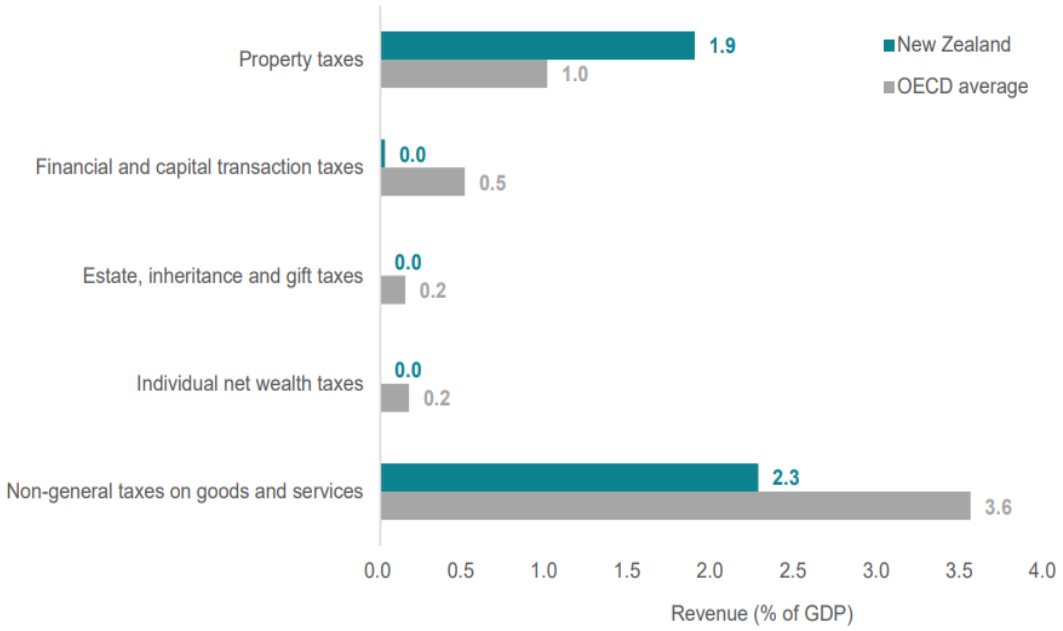
Source: OECD (2022)

[31] This figure adjusts for the GST on the salary and wage component of public services. See footnote 14 of the Environmental Scan.

[32] The VRR is calculated as: VAT Revenue / [(Consumption – VAT revenue) x standard VAT rate]. Consumption is Final Consumption Expenditure in national accounts. It combines the effect of exemptions, lower rates and revenue leakage.

Figure 10 shows that beyond income tax and GST, New Zealand generally makes less use of smaller tax bases than other OECD countries. As a share of GDP, New Zealand raises more revenue than the OECD average from recurrent immoveable property taxes (being rates in New Zealand), but less revenue from specific consumption taxes, individual wealth taxes, inheritance, estate and gift taxes, and financial and capital transaction taxes.

Figure 10: Revenue from other tax bases as a percent of GDP, 2021

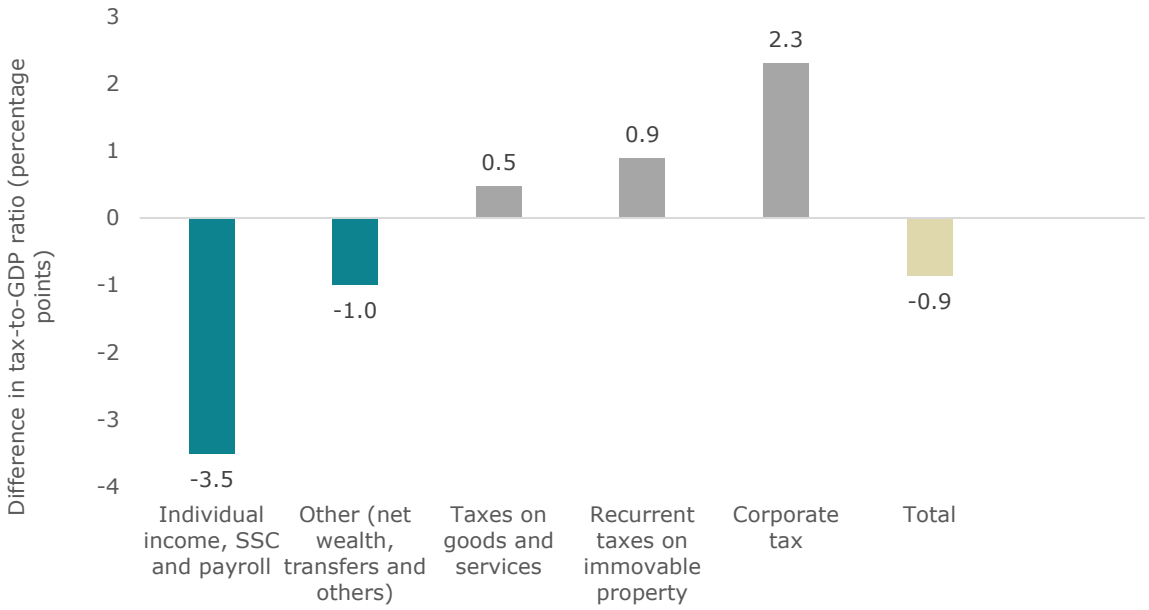


Source: OECD (2024)

Bringing large and small tax bases together, Figure 11 breaks down the difference in New Zealand's tax-to-GDP ratio compared to the OECD average. Positive numbers show bases from which New Zealand raises more revenue as a share of GDP compared to the OECD average, and negative numbers show bases from which New Zealand raises less revenue. In sum, compared to the OECD average:

- New Zealand has significantly lower individual level taxes as a portion of GDP when SSCs and payroll taxes are included.
- New Zealand has lower individual wealth taxes, inheritance, estate and gift taxes, and financial and capital transaction taxes as a portion of GDP.
- For all taxes on goods and services (on a comparable basis), New Zealand raises slightly above the OECD average from these taxes relative to GDP.
- New Zealand's level of recurrent immoveable property taxes is almost 1 percentage point of GDP higher than the OECD average.
- New Zealand raises a significantly higher portion of GDP from corporate tax than the OECD average.

Figure 11: Decomposition of difference in OECD average tax-to-GDP ratio and New Zealand tax-to-GDP ratio, 2021



Source: OECD (2024)

Chapter 4 – Income Tax

Overview

This chapter looks at possible modifications to New Zealand's system of income tax. Given the focus of this LTIB on addressing long-term fiscal pressures, the key focus is on possible modifications to the income tax that may make it more flexible to changing revenue needs over time.

Inland Revenue sees two main areas that reduce the flexibility of the existing income tax to changing revenue needs:

- comprehensiveness of the income tax base, and
- the integration of personal and company taxation.

Comprehensiveness of the base: While New Zealand's income tax generally has a broad base, one key way in which the base is narrower than the norm in OECD countries is that New Zealand does not have a general tax on capital gains. This has implications for efficiency and equity and reduces the flexibility of the tax system to changing revenue needs by making revenue raising to finance spending more costly than necessary. However, capital gains taxes come with pros and cons. While taxing more capital gains may improve the neutrality of inter-asset savings choices and there are equity arguments for taxing more capital gains, realisation-based capital gains taxes come with efficiency costs in the form of lock-in, can have high compliance costs and place a burden on risk-taking. The 2019 Tax Working Group (TWG) estimated that in the long term a capital gains tax would generate around 1.2% of GDP in revenue in New Zealand.

Personal–company integration: When top personal tax rates are substantially higher than the tax rate applying to entities, there will be incentives to shelter income in entities. In terms of constraints on the flexibility of the tax system, Inland Revenue sees the key issue as the integration of personal and company taxation. There are difficult trade-offs in setting rates for personal and company taxation. It is desirable to ensure the company tax rate is not too high, to not discourage foreign investment. However, raising sufficient revenue in a way that meets different governments' distributional goals may require personal rates higher than the company rate. Chapter 4 looks at some mechanisms to improve integration of the personal–company boundary under New Zealand's current income tax. The most effective mechanism is likely to be a tax on share sales, although this will not fully remove the incentive to shelter income in companies.

Chapter 4 also looks at whether a dual income tax provides a more flexible tax system by providing a better balance between equity and efficiency goals if revenue needs increased. In particular, we consider if a dual income tax provides a more robust approach to managing rate differentials between company and personal rates.

4.1 Scope of chapter

4.1.1 This chapter focuses on possible improvements, or modifications, to New Zealand's system of income tax. As noted above, there are good reasons for New Zealand to continue with an income tax as a main tax base. By income tax we mean both the personal tax regime under which individuals are taxed at progressive rates and the various entity regimes that tax income.

4.1.2 Given the focus of this LTIB on long-term fiscal pressures, a particular concern considered is possible modifications to the income tax system that may increase its flexibility to raise more revenue in a way that is fair and efficient, should that be required. This chapter also considers whether a general income tax (GIT) or a dual income tax (DIT) is likely to provide more flexibility to meet changing revenue needs over time in a way that is most efficient and equitable.

4.1.3 This chapter proceeds as follows. Section 4.2 discusses what Inland Revenue sees as the key issues that may limit the ability of the income tax to adapt to changing revenue needs. Section 4.3 discusses the comprehensiveness of the income tax base. Section 4.4 discusses the integration of individual and entity taxation. Section 4.5 concludes.

4.2 Key issues

4.2.1 New Zealand's income tax is based on the concept of a comprehensive income tax. As discussed in Chapter 2, the base of taxation for a comprehensive income tax can be defined as the amount that can be consumed in a period while leaving wealth unchanged. The aim of a comprehensive income tax is to tax income broadly because this tends to keep efficiency costs low and support horizontal equity.

4.2.2 An idealised comprehensive income tax base would include both income from labour and income from capital owned by domestic residents including a tax on accruing capital gains. This would be the intended base of taxation for both a comprehensive GIT and DIT.

4.2.3 Chapter 3 discussed several reasons why a real-world income tax will necessarily fall short of taxing income comprehensively. This includes that the tax base will often differ from the economic concept of income for practical reasons and due to the effects of inflation and because imputed rental income is rarely taxed under an income tax. Income can also be earned through entities, rather than directly, which can make it hard to apply a consistent approach to taxation at the individual level.

4.2.4 Of these issues, the two that we focus on in this chapter with application to New Zealand's specific circumstances are:

- comprehensiveness of the income tax base, and
- integration of entity and personal taxation.

4.2.5 These factors can lead to important gaps or variation in tax rates for both labour and capital income in New Zealand. As noted in Scheuer and Slemrod (2020), when different

kinds of income are subject to different effective tax rates, so that higher-taxed income can be converted into lower-taxed income, this will increase the efficiency costs of taxation and gives rise to equity issues. These factors also mean that when the government attempts to increase revenue through increases in personal tax rates, some of the intended revenue increase will be lost as income is converted to lower taxed forms, thereby reducing the flexibility of the income tax to increase revenue.

4.2.6 We discuss these areas in turn.

4.3 Comprehensiveness of New Zealand's income tax base

4.3.1 While New Zealand tends to have relatively broad bases on both labour and capital income compared to other OECD countries, a major way in which the base of New Zealand's income tax is narrower than that of most other OECD countries is that New Zealand only taxes a limited set of capital gains.

4.3.2 Regarding income from investments (capital income), New Zealand does tax capital gains when they meet certain definitions broadly linking the gain to business or trading activity and those linked to financial arrangements. Whether gains are taxable can depend on the intention of the holder at the time of purchase, which can be hard to gauge. Capital gains on residential rental property are taxable if the holding period for the property is less than two years and certain other land transactions may also be taxable.

4.3.3 Regarding labour income, non-taxation of capital gains can mean that labour effort devoted to increasing the value of assets (such as improving a rental property or building a business), can be taxed at lower rates or not taxed. Recent international work illustrates that labour income can be captured in capital gains. Advani et al (2024) provide two pieces of quantitative evidence that in the UK (where capital gains are taxed at a lower rate than other income) a large share of capital gains are, in fact, the returns to labour rather than capital. This ability to recharacterise income was particularly acute for owner–managers in the UK, particularly in industries where income-shifting, to have labour income taxed as capital gains, is most feasible such as personal services industries.

4.3.4 Non-taxation of capital gains can provide avenues for individuals to reduce their tax liability by undertaking activities that are not taxed rather than those that are taxed or by retaining income in entities (discussed below). This is likely to limit the flexibility of the income tax system to adjust to differing revenue needs by making revenue increases to fund increased spending more costly than necessary. Non-taxation of capital gains also has implications for equity and efficiency, although there are mixed efficiency impacts of capital gains taxes. Here we consider the pros and cons of capital gains taxes drawing on recent work from the OECD (Hourani & Perret (2025)) and evidence from Australia.

Taxing capital gains

4.3.5 OECD countries generally tax capital gains, although they are generally taxed more favourably than other forms of income and often taxed separately to labour income. Approaches vary across OECD countries, although capital gains on the main home are usually exempt from tax.

4.3.6 For the practical reasons discussed earlier, no OECD country attempts to tax accruing capital gains generally and therefore capital gains taxes are usually applied on a realisation basis. The following discussion assumes a capital gains tax (CGT) would apply on a realisation basis for most assets.

4.3.7 Extending the taxation of capital gains has been considered in New Zealand several times. Views have differed, particularly on whether capital gains should be taxed comprehensively or only for some additional assets. The 2019 TWG noted that decisions on extending the scope of capital gains tax depend on balancing considerations in terms of fairness, integrity and efficiency benefits against administrative complexity, compliance costs and efficiency costs. Differing views on the scope of capital gains taxation represent different weightings put on these factors.

4.3.8 Taking these factors into account, the majority of the 2019 TWG recommended taxing most capital gains. A minority recommended that the extension of CGT be limited to residential investment property only. The McLeod Review did not recommend a CGT but suggested using the risk-free return method (RFRM) for savings and investment entities. Similarly, a majority of the 2010 Victoria University of Wellington (VUW) Tax Working Group did not recommend taxing capital gains but suggested RFRM for residential investment property.

Taxing realised capital gains

4.3.9 A realised CGT can be assessed in terms of its impact on revenue, efficiency and equity.

Revenue

4.3.10 The most recent revenue estimate for taxing capital gains in New Zealand was done for the 2019 TWG report. The accuracy of any estimate is highly dependent on the regime design, including the assumed rate, and revenue will fluctuate substantially with economic conditions. The TWG estimated that if the tax applied at normal rates and took effect from 2021/22, it would raise about $3 billion per year in 2025/26 (0.7% of GDP). Revenue, while volatile, would be expected to increase over time and in the long term fluctuate at around 1.2% of GDP (TWG Final Report, Table 5.2). This estimate considered only real property (excluding the main home) and shares in domestic listed companies as being in the base. Slightly over a third of the revenue was generated from residential rental property and second homes. Other appreciating assets, such as shares in private companies or shares in Australian listed companies, were not included in the estimate.

4.3.11 This estimate is in line with revenue raised in other countries from capital gains taxes. Recent work by the OECD (Hourani & Perret, 2025) shows capital gains from individuals

in the US, UK, Australia and Canada are volatile and fluctuated between 1% and 6% of GDP in the 20 years prior to 2020 (although for countries other than the US, capital gains were generally less than 4% of GDP).

4.3.12 Revenue from capital gains could therefore make a meaningful contribution to addressing long-term fiscal challenges. However, as noted in the Overview, the last Treasury LTFS projected an operating deficit of 13.3% of GDP by 2061 under current settings. Therefore, even with more comprehensive taxation of capital gains other tax or expenditure measures would be needed in the longer term. Therefore, Inland Revenue considers that it is also important to consider how to increase the flexibility of the tax system to changing revenue needs.

Efficiency

4.3.13 A full review of the literature on the efficiency impacts of capital gains taxes is beyond the scope of this paper. Here we summarise recent work from the OECD (Hourani & Perret (2025)). This paper summarises the efficiency arguments for and against taxing capital gains:

- *Economic distortions:* Non-taxation of capital gains can influence individuals' decisions on several margins, including by diverting the allocation of both labour and capital away from activities with the highest economic return. This will have economic costs. Box 6 shows a realisation-based CGT would reduce but not eliminate this distortion.
- *Effect on savings and investment:* Taxing capital gains would increase the tax on savings. However, Hourani & Perret (2025) note that there is little academic literature providing support for the view that taxing capital gains will reduce savings,[33] investment or entrepreneurship. In part this is because tax differentials between different forms of savings can lead to individuals reallocating rather than increasing savings, and hence taxing capital gains can reduce distortions in asset allocation. Regarding investment, when foreign investors provide a significant share of investment, as is the case for a small open economy like New Zealand, domestic capital gains taxes will have less effect on investment levels than in larger economies.
- *Lock-in*: The lock-in effect occurs when individuals hold assets instead of selling them to delay paying taxes. It stems from the realisation basis of a CGT, which makes it possible to defer the payment of tax on accrued gains. The lock-in effect has efficiency costs from the misallocation of capital. Hourani & Perret (2025) note that empirical evidence supports that individuals do defer realisations as gains are taxed more heavily. Further, there is evidence that individuals time the realisation of gains to periods when they have lower tax rates, although tax will not be the only factor when individuals defer gains until they are elderly and have limited alternative income (see paragraph 4.3.20).
- *Double taxation of corporate profits*: An argument for favourable tax treatment of capital gains on shares is that in the presence of corporate income tax, taxation of domestic share sales amounts to double taxation of retained earnings. This

[33] As noted earlier, taxes on savings can still have efficiency costs from the substitution effect even if aggregate savings are not reduced.

argument is complicated by the fact that some of the incidence of corporate tax is likely to be borne by employees. Further, not all gains on shares arise from retained earnings. Therefore, this is not an argument for full exemption of capital gains on shares.[34] Further, double taxation of retained earnings can be eliminated by allowing the cost price of shares to be stepped up by the amount of retained earnings that have already been subject to corporation tax (see below). A major reason for taxing capital gains from shares is to reduce incentives to retain earnings in companies and therefore avoid higher personal tax rates. This is discussed in the next section.

- *Inflationary gains*: If the CGT base is not adjusted for inflation, tax may be levied on gains that exceed economic gains. However, when gains are taxed on a realisation basis, the benefit of capital gains deferral counteracts the effect of inflation. Further, the compensation for inflation on other forms of capital income, such as interest income, is taxed and hence the treatment of inflation is not an issue limited to capital gains. Some countries, however, provide an explicit inflation adjustment for capital gains.
- *Lumpiness of gains*: Large capital gains may push taxpayers into higher tax brackets under progressive tax rate schedules. However, as noted, some individuals time gains for periods when they have lower tax rates. Further, some countries have arrangements that allow for the spreading of gains or backwards averaging to mitigate this effect.

4.3.14 In addition to the issues identified by Hourani & Perret (2025), there is an issue of asymmetries in the treatment of gains and losses. Often capital gains taxes will allow capital losses to be offset only against capital gains or carried forward without interest to be set off against future capital gains. This means that the government taxes a greater share of gains than it is subsidising of losses, which can discourage risk-taking.

4.3.15 From an efficiency point of view, the case for CGT therefore largely depends on the relative distortion from the misallocation of labour and capital from certain activities being tax preferred versus the misallocation of capital that arises from the lock-in effect and asymmetries in the tax treatment of gains and losses.

Box 6: Realised capital gains taxes reduce but do not eliminate distortions

To illustrate how a realisation-based CGT can reduce distortions in asset allocation assume a taxpayer on a 30% marginal tax rate. This individual could earn $500 of taxable income or make a capital gain of $351. They would be better off making the capital gain if there is no CGT. However, in this case New Zealand misses out on $149 of value.

However, a realisation-based CGT does not fully reduce this distortion. If capital gains are taxed only on realisation, it would still be attractive to make capital gains of $351 ahead of earning $500 of taxable income if the asset could be held onto forever and never sold. In this case there would be no tax. However, if gains cannot be endlessly deferred, a realisation-based CGT will narrow the number of cases when people have incentives to earn capital gains ahead of more productive but fully taxed alternatives.

[34] Scheuer & Slemrod (2020) note that only five OECD countries levy no tax on shareholders based on capital gains. Of those that do, the tax is based on realised gains.

4.3.16 Capital gains taxes can also give rise to high compliance and administrative costs. This will depend on design and the particular assets subject to the capital gains tax. Compliance costs are likely to be higher for assets that do not have readily available valuations such as unlisted equity.

Equity

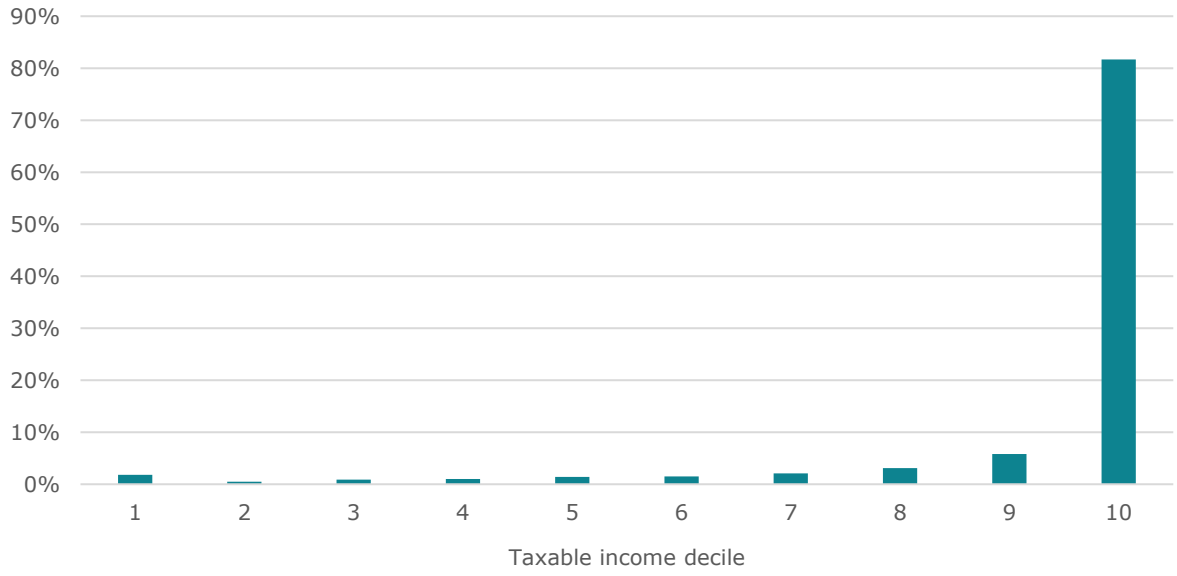
4.3.17 There are both horizontal and vertical equity arguments in favour of taxing capital gains. Studies in New Zealand, including the Inland Revenue (2023) High Wealth Individuals Research Project and Ching et al (2023), have shown that capital gains are among the income forms most skewed towards higher income or wealth individuals. Further, without a CGT, economic rents and some forms of labour income can be untaxed. Therefore, not taxing capital gains comprehensively reduces the effective progressivity of the personal tax system.

4.3.18 This is consistent with international studies. For example, the OECD in Hourani & Perret (2025) notes that research shows that realised capital gains are disproportionately concentrated among top earners. In the UK, the top 5,000 taxpayers received more than half of all taxable gains in 2020. Tax statistics for the US and Canada show that individuals in the top 0.1% of the income distribution receive an outsize share of realised net capital gains (around 50% for the US and 30% for Canada). Scheuer and Slemrod (2020) provide that IRS data in the US shows that in 2014 realised capital gains represented 60% of the total adjusted gross income (AGI) for the 400 highest-AGI Americans. They note that realised capital gains are a very high fraction of the income of the super-rich in the US.

4.3.19 Analysis from Australia (Minas et al, 2023), based on income tax returns from the 2019–20 tax year, found that most capital gains that are realised are relatively modest, with a small proportion of taxpayers realising much larger gains. Indeed, 0.89% of taxpayers with capital gains accounted for 29% of the total dollar value of taxable gains (and these taxpayers would be in the top personal tax bracket even without the capital gains). The Australian Treasury (2024) report on the effect of the 50% capital gains discount in their Tax Expenditure and Insights Statement (TES).[35] Figure 12 shows that in 2020–21, 82% of the total benefit of the discount was received by people in the top income decile (75% in 2019–20). Men received 62% of the benefit of the CGT discount, reflecting the underlying distribution of capital gains between men and women. The age when individuals received the largest benefit was in their 50s in 2020–21.

[35] Tax Expenditures and Insights Statement The 50% discount applies to any nominal capital gain made by a resident individual or trust when an asset has been owned for at least 12 months (only half the gain is taxed). In the TES, the benchmark is that realised capital gains are assessable at the taxpayer's marginal tax rate in the year they arise.

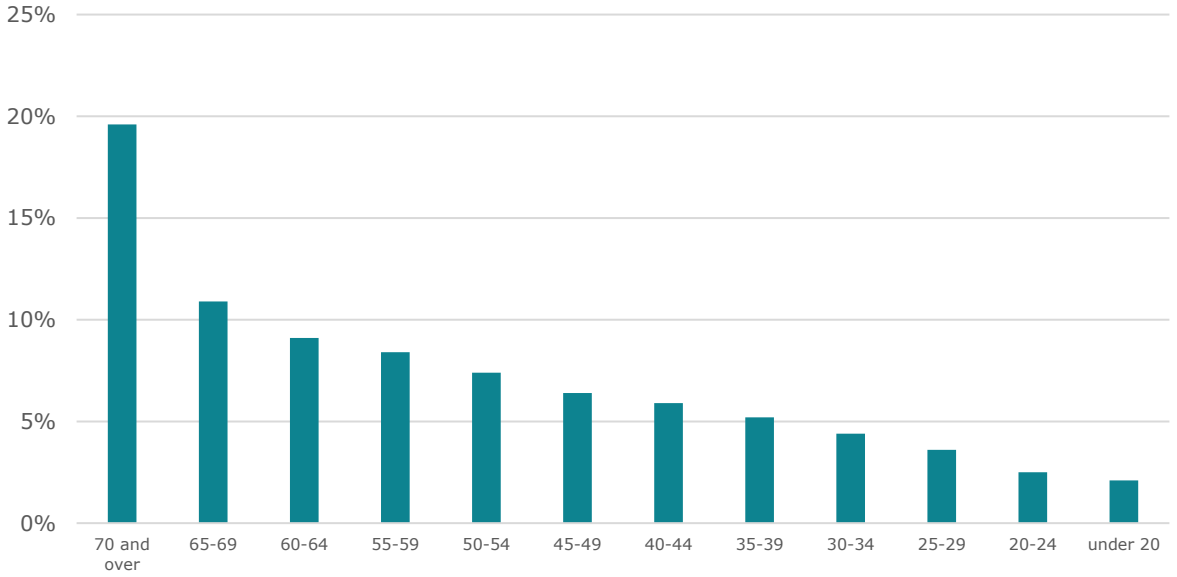
Figure 12: Share of benefit of CGs discount by taxable income decile, Australia 2020–21



Source: Australian Treasury (2024)

4.3.20 The Australian analysis by Minas et al also looked at the age profile of those realising capital gains. It showed that as the age of taxpayers increases, their propensity to realise capital gains also increases. For example, as shown in Figure 13, the percentage of taxpayers realising capital gains in the age range "70 and over" is 19.6% compared to 10.9% for taxpayers in the 65–69 age range, and less than 5% for those aged under 30. Matching with salary and wage data showed that older taxpayers were tending to realise their capital gains for consumption in years when they had no salary and wage income and when their taxable income is relatively low.

Figure 13: Percentage of taxpayers by age category realising CGs in Australia



Source: Minas et al (2023)

4.3.21 Transitional fairness would be a consideration if a general CGT were to be brought in for New Zealand. If a CGT were applied to the future gains of existing investments, then government is effectively changing the after-tax return on an existing investment. On

the other hand, if new rules were only to apply to future investments it would be a long time before the full effect of the reform was realised.

Risk-free return method

4.3.22 As noted, the McLeod and VUW Reviews suggested using the RFRM to tax income from certain assets that is not comprehensively taxed under the current income tax. The McLeod Review Final Report recommended "that the RFRM method be considered for the specific problem of disparate tax treatment of different savings entities. This continues the past approach of dealing with specific capital gains issues as they arise".

4.3.23 The McLeod Review argued for an RFRM for savings and investment vehicles on the basis that it would provide a more comprehensive and consistent method of income taxation for different savings and investment vehicles than existed at the time. Since this time, the PIE regime has been introduced for savings and investment vehicles.

4.3.24 Chapter 2 described the RFRM and shows that it is similar in effect to a wealth tax. An RFRM would tax the normal return but would not levy any taxes on labour income, economic rents or the excess returns to risk-taking.

4.3.25 To be applied, an RFRM requires accurate market valuations, and it can also lead to liquidity issues because it is applied regardless of when the asset is realised. Overall, Inland Revenue considers this method only makes sense for a limited set of asset classes.

Savings neutrality

4.3.26 Estimates from the OECD suggest that there can be significant variation in effective tax rates across different forms of savings in New Zealand.

4.3.27 Inconsistent taxation of capital gains is one factor that leads to this variation. Other contributing factors can be that the tax rate on PIE income is capped at 28% and the use of different approaches to calculate the income from investments. For example, overseas portfolio investments (such as those managed by KiwiSaver funds or via online share accounts) face a variety of tax rules including a 5% fair dividend rate, full tax on gains, no tax, or tax on the unrealised gain in a year depending on the exact nature of the holding. Inflation also affects different investments differently with, for example, the real return from interest generally highly taxed.

4.3.28 While the methodology used by the OECD is a useful baseline to understand the effective tax rates on different savings forms, there are a number of assumptions that are not necessarily well suited to the New Zealand context and some limitation of this methodology. Inland Revenue is considering developing this methodology for the final LTIB and seek submitters views on whether further work on the variability of effective tax rates on different forms of savings would be valuable.

4.4 Individual and entity regimes

4.4.1 Only individuals earn income in the economic sense. However, the taxable unit may be an individual or an entity. By entity we mean a taxable unit other than a natural person.

4.4.2 One principle that New Zealand's income tax is generally built on is that all income, whether earned directly or through an entity, should be taxed at as close to personal tax rates, on a present value basis, as is practically possible. This requires approaches to integrate the personal taxation system and entity taxation. The existence of entity regimes, however, will mean that there is never full alignment with personal tax rates in present value terms and some trade-offs are required.

Overview of different entity tax regimes

4.4.3 The main entity regimes that apply under New Zealand's tax system are the company tax regime, the portfolio investment entity (PIE) regime and the trust regime (noting trusts are not a legal person). New Zealand's tax system also recognises Māori authorities and other types of entities such as funds and associations.

4.4.4 Table 8 describes the main entity tax regimes and what is taxed at the entity and personal level for residents. Each of these regimes provides an approach to integration with the personal tax system but it differs between regimes.

Table 8: Main entity regimes in New Zealand

	Entity level	Personal level
Company	Company income taxed at 28%.	Distributions taxed at personal rate but subject to imputation credits that account for the payment of company tax.
PIE	PIE income taxed at personal tax rates but capped at 28%.	No further personal tax.
Trust	Trustee rate 39% for trusts with income over $10,000. Otherwise, 33%.	Income distributed to or vested in beneficiaries within a year taxed at beneficiary rate. Otherwise, the trustee rate applies.
Māori authority	Māori authority income taxed at 17.5%.	Distributions taxed at personal rate but subject to a Māori authority credit that accounts for the payment of authority tax.
Partnerships	Not taxed as an entity.	Income taxed on a flow-through basis, when the taxable income is attributed to the owners according to their ownership percentage.

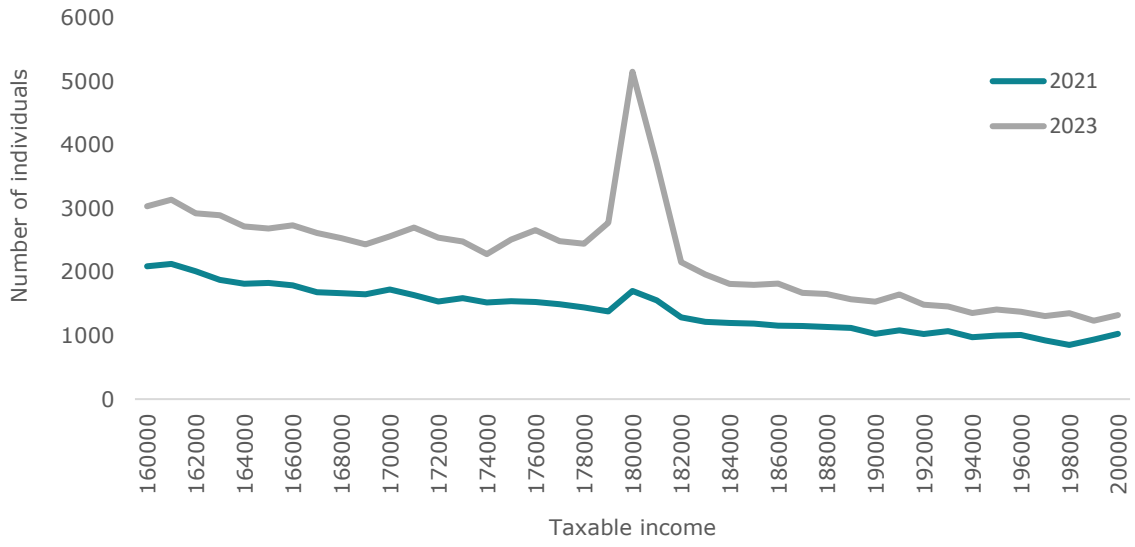
Issues regarding integration of entity and personal taxation

4.4.5 A key focus in this chapter is on constraints in New Zealand's income tax system that may make it less flexible to adapt to changing revenue needs over time. Under New Zealand's current system, there is not full integration of the personal tax regime and

entity regimes resulting in differences in tax rates depending on how income is earned. This can provide opportunities for individuals to earn income through entities and therefore not pay top personal tax rates with implications for revenue adequacy.

4.4.6 Figure 14 shows that many individuals earn income right at the point where a higher personal tax rate applies. A bunching of incomes at the $180,000 threshold can be seen after the 39% top tax rate was introduced for the 2022 tax year, but this did not substantially exist prior to that. This may be partly due to the higher tax rate discouraging working or earning more but also suggests some of the income above the threshold is being earned through entities rather than declared as personal income.

Figure 14: Reported income bunch at the threshold of $180,000



Source: Inland Revenue

4.4.7 The issues differ for each entity regime. Here we look at the extent to which a divergence between entity and personal rates is likely to limit the flexibility of the income tax to adapt to changing revenue needs under each regime.

4.4.8 Having a company rate lower than top personal rates provides opportunities for individuals to shelter income in companies with sheltering incentives increasing as this gap increases. This issue is particularly acute in the absence of a tax on gains on share sales because there is no further tax on retained earnings unless distributed. International empirical evidence suggests that the incorporation of businesses typically increases when there are significant differences in personal and corporate income tax rates (Zawisza et al, 2024).

4.4.9 Inland Revenue considers that the company–shareholder boundary is a key issue to consider regarding flexibility of the tax system. This is discussed further below. We discuss the trade-offs regarding setting the company rate versus personal rates. These trade-offs mean that alignment of the company and top personal tax rate will not always be the best approach. We therefore focus on approaches that may mitigate the effects of rate differentials.

4.4.10 The trustee rate is currently aligned with the top personal rate for trusts with income over $10,000. Trusts with income below this threshold are taxed at 33%. When trust income is distributed to, or vested in, beneficiaries within a year of being earned it is taxed at the beneficiary rate. These mechanisms seek to align the taxation of trust income with the personal tax rates of the underlying beneficiary while avoiding opportunities to shelter income in trusts. Keeping the trust rate aligned with the top personal rate, while allowing mechanisms to ensure lower income beneficiaries are not overtaxed, will support the flexibility of the personal tax system going forward. We do not discuss trusts further in this LTIB.

4.4.11 PIE income is not fully integrated with the personal system because it is taxed at a maximum rate of 28% to align with the company tax regime. However, PIEs have more restrictions on their ability to be used to hold assets and earn income than a company (they can only own portfolio investments and real estate and must be owned by at least 20 investors). This means they cannot be used to hold controlled investments or operate businesses. Therefore, PIEs are unlikely to be a vehicle to be used to conceal labour income or economic rents. Further, PIE tax is currently less than 2% of income tax, and around 1% of total tax (although this will likely increase over time). Inland Revenue sees the appropriate taxation of PIE income as more fundamentally related to the question of the appropriate taxation of savings rather than the flexibility of the tax system. Note that under a DIT, PIE income would be taxed at the lower capital taxation rate. For these reasons we do not discuss PIEs more in this section.

4.4.12 The tax rate for Māori authorities is set based on the assumed underlying tax rate of the underlying investors. Following this principle will ensure good alignment of this regime and the personal regime.

4.4.13 For these reasons Inland Revenue sees the integration of company and shareholder taxation as the main entity–personal regime issue affecting revenue adequacy and this LTIB therefore focuses on this issue. Below we look at approaches that could be used within the current tax system to improve integration. We also investigate whether a dual income tax manages personal–company integration better than a general income tax.

Company–personal integration

Objectives

4.4.14 Company taxation is designed to meet somewhat opposing objectives:

A withholding tax for income earned by resident shareholders

4.4.15 The company tax regime allows income earned by residents through companies to be taxed as it is earned. If the tax impost were fully deferred until when dividends are paid, the effective tax rate on the income would be much lower in a present value sense. There are practical benefits in taxing company income at a flat rate (rather than shareholder rates) as it is earned, particularly when there are many shareholders.

4.4.16 In New Zealand, when company income is distributed as a dividend, the shareholder is taxed at their personal tax rate, with a credit (imputation credit) for their share of the company tax paid. This allows distributed income to be ultimately taxed at the shareholders' tax rates, while preventing double taxation. Shareholders with tax rates above the company rate will pay a top up, while those with tax rates below the company tax rate receive a (non-refundable) credit. However, because distribution of income may occur sometime after the income is earned, tax paid will diverge from personal tax rates due to the time value of money. Further, if income is not distributed but rather shares are sold the income will not be taxed at personal rates.

4.4.17 Dividend imputation is consistent with the concept of a progressive comprehensive income tax. As Sorensen (2007) states, the comprehensive income tax is based on the idea that all the taxpayer's income – regardless of its form – should be taxed in the same manner. In such a system, the corporation tax would serve only as a preliminary withholding tax that would be fully credited against the personal tax on corporate source income, so avoiding double taxation.

4.4.18 However, dividend imputation is now a relatively uncommon system internationally. According to the OECD's classification, only six OECD countries have imputation systems: Australia, Canada, Chile, Korea, Mexico and New Zealand (Hourani et al, 2023). Internationally, it is more common to follow a classical taxation system under which (net of company tax) distributed income is taxed at the shareholder's personal rate without a credit for company tax. A classical system results in distributed income being taxed at a higher rate than personal tax rates. This approach is therefore inconsistent with an approach that seeks to tax all income, no matter how it is earned, at as close to personal tax rates as is possible. Classical taxation can also create a disincentive for domestic residents to invest in a company or to carry on a business through a company. Many countries with classical taxation have modified it by reducing the tax rate that applies to dividends, or only subjecting part of the dividend to tax, or, as discussed below, allowing extensive use of flow-through tax treatment (that is, taxing business income directly at personal rates).

A final tax for domestic investment by non-residents

4.4.19 As discussed in Chapter 3, there are economic benefits from not taxing marginal investment into New Zealand by non-residents too highly. This is because this tax is shifted onto domestic factors, for example through lower wages in New Zealand.

4.4.20 Company tax also taxes capital income from equity investments earned by non-residents in New Zealand. A lot of non-resident investment in New Zealand is made through a New Zealand company.[36]

4.4.21 The company is taxed at 28% as income is earned. When dividends are paid to non-resident shareholders, the non-resident is not directly taxed. However, if the company has not paid company tax on the distributed dividend, non-resident withholding tax

[36] There are some other ways for non-residents to invest in New Zealand such as directly owning assets located in New Zealand or investing in a partnership.

(NRWT) of 15%, or 30%, will be applied if the investor is not resident in a double tax agreement (DTA) partner country.[37] This means in many cases the company tax rate (and provisions such as depreciation) will determine the tax rate on foreign equity investments.

4.4.22 These competing considerations create a trade-off between:

- keeping the company tax rate low enough to not unduly discourage foreign investment
- keeping the company tax rate low enough to not unduly over-tax domestic residents on personal tax rates lower than the company rate, and
- having a company rate that provides an appropriate withholding rate for domestic residents on higher personal tax rates so that sheltering opportunities are minimised and they pay tax near their personal rate.

4.4.23 Figure 15 shows that New Zealand has a low gap between its top personal tax rate and company tax rate compared to other OECD countries. This is in part because New Zealand has a relatively high statutory company tax rate, as shown in Figure 16.

4.4.24 In 2023, New Zealand had the eighth highest company tax rate in the OECD. As noted earlier, most other countries operate a classical tax system and therefore the total impost on residents may be relatively high in some other countries with the low company rate benefitting non-residents.

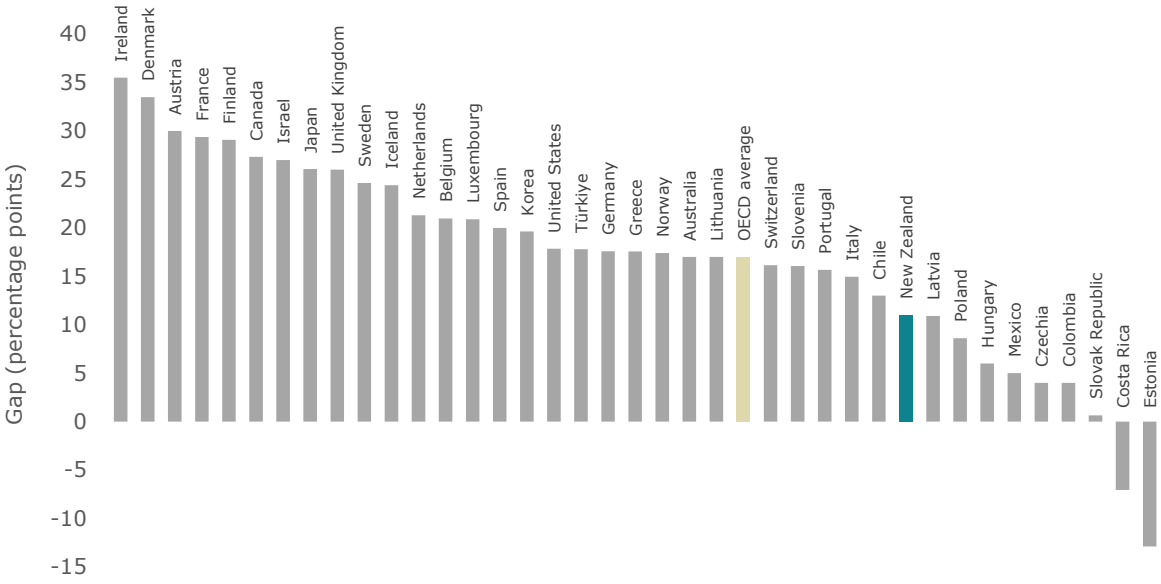
4.4.25 New Zealand's company tax rate is part of the reason that New Zealand has relatively high effective marginal tax rates (EMTRs) on inbound investments compared to other OECD countries (Inland Revenue, 2022).[38] The EMTR is the proportion of the real pre-tax return on a marginal investment that is lost in tax.

4.4.26 Figure 17 shows OECD calculations for the unweighted average EMTR across four asset classes (buildings, inventories, tangible assets and acquired intangibles). In this scenario, the OECD calculated that New Zealand's EMTR was higher than all but three other countries in 2020.

[37] Under some DTAs, there is no dividend NRWT even if unimputed dividends are paid if the investment meets a substantial ownership threshold.

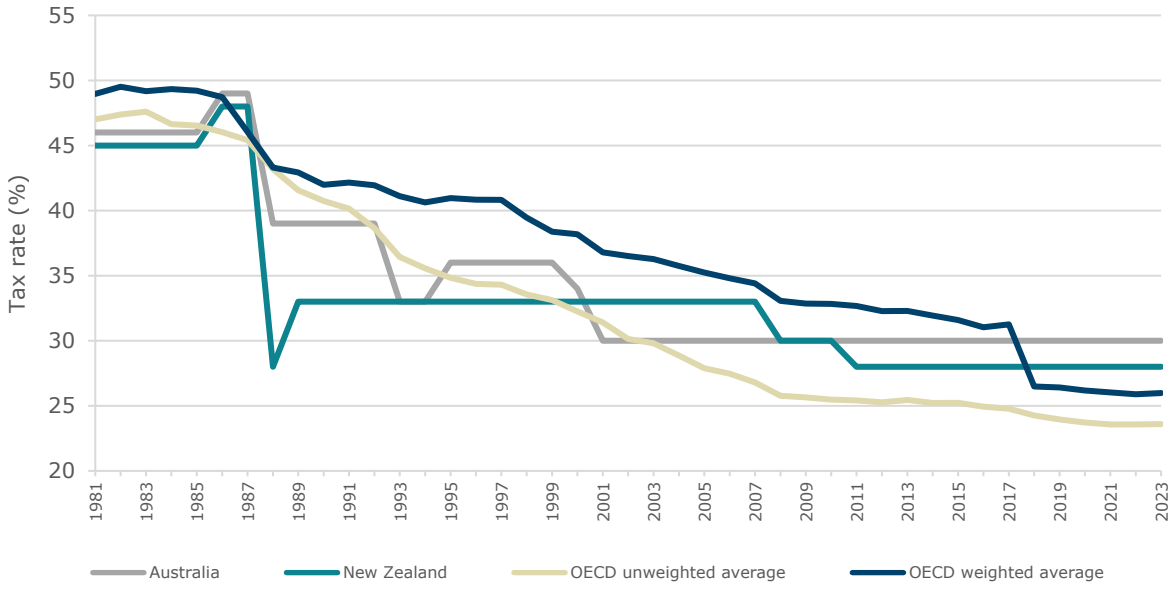
[38] In Figure 17, New Zealand's rate was calculated for 2020 when depreciation deductions were available for non-residential buildings and prior to the Budget 2025 Partial Expensing regime being implemented. A real interest rate of 3% and an inflation rate of 1% is assumed. See Hanappi (2018) for methodology.

Figure 15: Gap between statutory company and top personal rate, 2022



Source: OECD (2024)

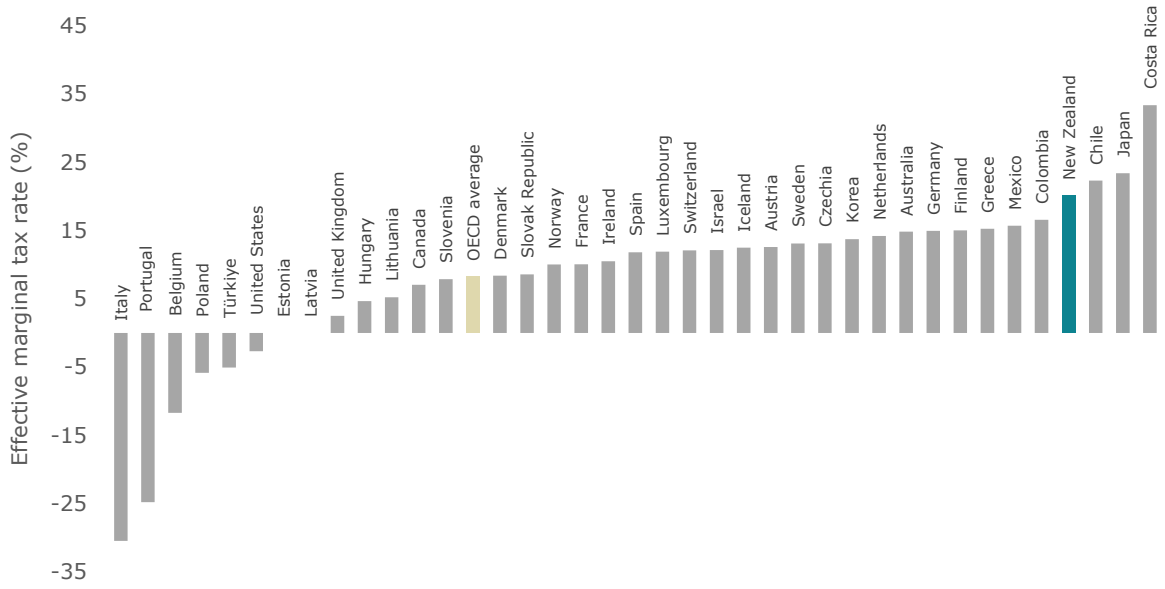
Figure 16: Statutory company tax rates, 1981–2023[39]



Source: OECD (2024)

[39] Figure 16 shows average statutory combined central and sub-central government tax rates for OECD members on 1 January 2024. Data is from the OECD's database, the Oxford University Centre for Business Taxation, Tax Foundation and Trading Economics.

Figure 17: Effective marginal tax rate, 2020



Source: OECD (2024)

4.4.27 These considerations argue against raising the company tax rate to address future fiscal pressures because this is likely to be a high-cost way to raise tax. However, Inland Revenue considers that raising adequate revenue in a way that meets future governments' distributional goals requires the system to be able to tolerate personal rates above the company rate.

4.4.28 Therefore, in the context of rising fiscal pressures a tax system built around the principle of alignment between the top personal rate and the company rate may not be durable. Arguably, this alignment was a core element of the design of the income tax system in the 1980s. However, New Zealand only sustained alignment between these rates for 11 years (1989 to 2000) and this was when the company tax rate was 33%, which would be high in international comparison today. Inland Revenue considers that a system that *requires* alignment between the top personal rate and the company rate is unlikely to be durable going forward because it is unlikely to have sufficient flexibility in the context of rising fiscal pressures.

4.4.29 A lack of alignment will, however, lead to variability in tax rates that can have implications for revenue adequacy, equity and efficiency. Therefore, we consider below the pros and cons of different approaches that could provide for more integration of company taxation and personal taxation. First, we look at changes that could be made to New Zealand's current income tax system. Then we look at whether a dual income tax provides a better approach to integrate personal–company taxation in a world where the company rate and top personal rate are not aligned.

Ways to improve integration of company and personal taxation under current income tax

4.4.30 Some options that could be used to strengthen the integration of the personal and company tax regime under the current system include:

- mandatory flow-through treatment for closely held corporations

- providing incentives to pay out dividends more frequently, and
- deeming certain realisation events as taxable.

Mandatory flow-through treatment for closely held corporations

4.4.31 Under flow-through treatment, income earned in an entity would be taxed at personal tax rates as it is earned. This is the current treatment for partnerships and sole proprietors.

4.4.32 The McLeod Review Final Report (pp 70–71) suggested that closely held companies should be taxed as partnerships or look-through companies (LTCs) with the capital and labour income flowing through to the owners to be taxed at their personal tax rate. As Sorensen (2007) notes, closely held corporations with active owners working in the business raise similar issues to the taxation of the self-employed. In particular, it can be difficult to distinguish the labour and capital component of income. Currently business owners can opt for flow-through treatment by establishing their business as a sole-proprietor or partnership. Submissions to the McLeod Review questioned the effectiveness of mandatory flow-through treatment.

4.4.33 Flow-through treatment of corporations is common in the US, although it is something corporations can opt into. The US system distinguishes between "C corporations" and "pass-through" firms such as sole proprietorships, partnerships, and "S corporations" (small business corporations). C corporations include all publicly traded firms, as well as some privately held firms. These firms face the corporate income tax. Taxpayers can elect to be an S corporation or otherwise structure as a pass-through. Pass-throughs include many architecture firms, doctors' offices, auto dealerships, beverage distributors, consulting and law firms, and other small- and mid-market regional businesses. The income (and losses) of these firms "passes through" each year to the owners' personal income. As a result, the owners pay individual income tax on profits each year so pass-through firms do not face corporate income tax. Pass-through firms make up about 95% of all US firms, but they account for only about half of business income (Chodorow-Reich, Zidar & Zwick, 2024). The US has a classical tax system so pass-through entities have a significant advantage in avoiding double taxation and passing through losses and therefore it is not surprising that most small businesses in the US opt into pass-through regimes. This suggests that extensive pass-through treatment becomes important to small- and medium-sized businesses in a country with a classical tax system.

4.4.34 Pass-through is a conceptually attractive option for closely held companies because it provides for greater alignment of the taxation of entity income with the personal tax structure, ensures that changes in the personal tax structure are fully effective for this income form, and prevents income shifting between labour and capital income in this case. However, it does raise some practical issues, for example, how to treat multiple share classes that do not have fixed income rights, how to manage selling shares in mid-year, and how to deal with different owners having different labour input. In addition, it introduces boundary issues around the shareholding structures of closely held companies versus widely held companies. If the latter has a preferential tax

treatment, there would be incentives to add shareholders to get the more favourable treatment.

Creating incentives to distribute dividends more frequently

4.4.35 Regimes can be designed to create incentives for companies to pay (or attribute) dividends more frequently or to deem dividends in certain instances. This would reduce the time of deferral of dividend payments and apply the shareholder top-up tax more frequently. This would make the effective tax rate on the income paid to or incurred by the shareholder more closely match their personal tax rate.

4.4.36 Regimes that do this include an accumulated earnings tax (the company is taxed when its undistributed earnings exceed a certain amount for a certain time period), and a surtax on passive investment earned by the company (as a proxy signal for a company accumulating funds that it is not re-employing in the business). Regimes such as these are not common and have been criticised for being complex and somewhat arbitrary and unreasonable proxies for an excessive deferral of payment of dividends.

Deeming certain realisation events as taxable

4.4.37 Rules could be developed to deem certain realisation events as taxable events, and this could reduce the ability to defer taxation through use of corporate structures. Hourani & Perret (2025) note that deeming certain realisation events as taxable events can have many advantages. It can reduce lock-in effects by limiting the scope for tax deferral, reduce tax-induced migration, enhance progressivity and reduce tax leakage. Realisation events could include death, the change of tax residence or the use of appreciated assets as collateral against loans.

4.4.38 An option in New Zealand may be to treat more shareholder events as dividends. The Income Tax Act 2007 already treats many transactions between companies and shareholders as dividends even if they are not dividends within the meaning of company law, such as providing benefits of company assets to shareholders for less than market value. Regimes could be considered that expand these, such as a more targeted deemed dividend realisation event when company shares are sold in some circumstances, such as when a share sale is significant enough to trigger a forfeiture of imputation credits.

4.4.39 Taxing shares when sold would remove a common method of realising value from accumulated company income without paying any additional tax. This would be one of the most effective ways to provide for greater integration of the personal and company tax regimes but can still result in significant deferral advantages. An objection to taxes on share gains is that it results in double taxation of the portion that is retained earnings. As discussed below, Norway has addressed this by allowing a step-up of share values by the risk-free rate, and prior to that by allowing a step-up of share values by the amount of retained earnings.

4.4.40 While all these mechanisms may improve personal–company integration, none will result in full integration and fully remove incentives to retain income in companies if top personal rates are above the company rate. We welcome views on the effectiveness

of these mechanism or any other ideas to improve personal–company integration. Next, we look at how this boundary is addressed under a DIT system.

How DIT deals with the company–shareholder boundary

4.4.41 A DIT system has a distinct approach to managing the company–shareholder (or personal) boundary compared to the current GIT system. The DIT model directly addresses the tension that exists when there is a substantial gap between the company tax rate and top personal rates, which Inland Revenue has identified as a key constraint on revenue flexibility. Chapter 2 outlined the general approach of DIT. The Norwegian shareholder model provides a good example of how DIT deals with the shareholder–company boundary.

Norwegian shareholder model

4.4.42 The Norwegian shareholder model allows for different rates to apply to labour and capital income while resolving many of the difficulties in distinguishing between capital and labour income that exist under other tax systems.

4.4.43 Following on from the earlier discussion in Chapter 2, the key elements of Norway's shareholder model include:

- A risk-free return shield (RFR shield) equivalent to the (post-capital tax) normal return component of income. This is calculated based on the risk-free government bond rates (which we will illustrate using 4%).
- Taxation of normal returns at the lower capital income rate (22% in Norway) via use of the RFR shield.
- Intentional double taxation of returns above the normal return to achieve a total effective rate approximating the taxpayer's marginal rate on labour income (approximately 46.7% in Norway for the top rate).

4.4.44 Under this system, normal returns to capital invested in companies are taxed at the lower capital income rate, while returns above this rate are effectively taxed at the taxpayer's personal rate. This is achieved without requiring the tax administration or taxpayers to determine subjectively whether income is from "labour" or "capital."

How it works in practice

4.4.45 To illustrate how the Norwegian shareholder model works in practice, consider this example:

Example 1: Dividend distribution

4.4.46 A taxpayer on the top personal rate contributes $1,000 to form a new company in exchange for 1,000 shares. The company earns profits of $100 (a $40 normal return and $60 excess return) and pays corporation tax of $22 (at 22%). It then distributes the remaining $78 as dividends. At the corporate level, both the normal return and excess return are taxed at 22%.

4.4.47 The taxpayer receives an RFR shield equal to $1,000 × 4% × (1 − 0.22) = $31.20. This represents the post-capital tax normal return on the invested amount and protects the

risk-free return from further taxation. To see this, if the company had only earned the risk-free return ($40 of income) and distributed all its after-tax income, the taxpayer would have received dividend income of $31.20. This is equal to the RFR shield so no extra tax would be paid on this income.

4.4.48 However, in our example when the company earns $100, the RFR shield reduces the taxable amount of the dividend to $78.00 − $31.20 = $46.80. The taxpayer pays dividend tax of $46.80 × 31.68% = $14.83, leaving a net dividend of $63.17. The 31.68% is calculated to result in a net tax rate of 46.7% on income above normal returns (the top personal rate), when personal taxation is combined with company taxation.[40]

4.4.49 The effective tax rate on the company's profits is therefore 36.83% (($14.83 + $22)/$100). The part representing a normal, risk-free return is effectively taxed at the lower 22% capital income rate ($40 * 22% = $8.80). However, the above-normal return is effectively taxed at a rate approximating the top personal rate ($60 * 46.7% = $28.03).

Example 2: Capital gains treatment and basis uplift

4.4.50 One other important feature of the Norwegian model is its treatment of capital gains on shares and the basis uplift mechanism. This creates neutrality for distribution decisions.

4.4.51 Assume a taxpayer owns shares with a basis (cost price) of $1,000. Over the year, the company retains earnings of $100 after paying corporate tax. The taxpayer's RFR shield for the year is $31.20 (4% × (1 − 0.22) × $1,000).

4.4.52 If no dividend is paid, the $31.20 RFR shield is added to the taxpayer's share basis, increasing it to $1,031.20. This basis step-up does two things:

- it recognises that the taxpayer has effectively reinvested the after-tax normal return component, and
- it prevents double taxation of the normal return when shares are eventually sold.

4.4.53 If the taxpayer sells the shares for $1,100 (reflecting the $100 of retained earnings), the taxable gain would be $1,100 − $1,031.20 = $68.80, rather than $100. This ensures that only the above-normal return component is subject to additional taxation.

No lock-in effect under the shareholder model

4.4.54 A significant advantage of the Norwegian shareholder model is that, for the shareholder, it effectively eliminates the "lock-in effect" that typically occurs with traditional capital gains taxes. Under conventional capital gains taxes, investors may delay selling appreciated assets because doing so triggers a tax liability. Therefore, investors are, for tax-driven reasons, creating inefficient portfolios.

4.4.55 The shareholder model overcomes this through the RFR shield. If an investor holds shares that have appreciated, their RFR shield continues to be calculated on the original cost basis. However, if they sell these shares and reinvest in new shares, their RFR shield

[40] In combination, 22% company tax and 31.68% personal tax equal an effective tax rate of 46.7% because (1 – (.78 * (1 – 0.3168)) = 46.7%.

for the new investment would be based on the higher reinvestment amount (their new cost basis).

4.4.56 For example, if a taxpayer has shares with a $1,000 original cost that are now worth $10,000, their annual RFR shield would be $31.20 (based on $1,000). If they sold these shares, paid the CGT, and reinvested the after-tax proceeds of approximately $7,150, their new annual RFR shield would be around $223.05 (4% × (1 − 0.22) × $7,150).

4.4.57 This higher RFR shield on the reinvested amount effectively compensates for the CGT paid, creating neutrality in the decision to continue holding versus selling and reinvesting. The present value of the tax burden is the same in either case, removing the tax-based incentive to hold appreciated assets. However, the lock-in effect will still occur for assets owned by companies, even if the shares that represent the equity of the company are not subject to lock-in.

Pros and cons of model

4.4.58 The Norwegian shareholder model offers several advantages for managing the company–shareholder boundary:

- Reducing income shifting incentives: By intentionally double-taxing returns above the normal rate, the system eliminates incentives to shelter labour income or economic rents in companies.
- Neutrality for distribution decisions: The RFR shield model, with its ability to carry forward unused allowances and the basis uplift, achieves neutrality for distribution and share sale decisions.
- Eliminating lock-in effects: Unlike standalone capital gains taxes, the Norwegian model removes tax-based incentives to hold rather than sell appreciated shares, improving portfolio efficiency.
- Allowing lower company tax rates: The DIT model allows for lower company tax rates to attract foreign investment while still ensuring domestic shareholders pay appropriate personal tax on above-normal returns.
- Automatic adjustment: The shareholder model automatically treats above-normal returns as effectively labour income or economic rents through its rate structure, avoiding the need for defining different income types and the creation of boundaries.

4.4.59 While the Norwegian shareholder model has significant advantages, it also faces several challenges that would need to be addressed if a similar system were implemented in New Zealand.

Non-neutral treatment of risk

4.4.60 The shareholder model is not entirely neutral in its treatment of risk. Under Norway's system, unused RFR shields can only be used to offset dividends and gains on the same shares. If a taxpayer makes losses on a particular share but does not earn sufficient taxable income from that share to fully use the carried forward RFR shields, the unused RFR shields are essentially lost.

4.4.61 For example, if a taxpayer purchased shares for $100, accumulated unused RFR shields of $30 (increasing the share basis to $130), and then sold the shares for $110, they would not derive any taxable gain or loss on the sale. However, $20 of the accumulated RFR shields would be lost. This creates a bias against risk-taking because the benefits of RFR shields cannot always be fully used in downside scenarios.

Potential avoidance issues

4.4.62 Several avoidance risks arise under the shareholder model:

- Business owners have incentives to transfer low-yielding non-business assets (for example, private cars or houses) to the company to increase the "capital" base for RFR shield calculation.
- Since interest income is only taxed once but dividends are taxed twice, taxpayers have incentives to debt-fund companies and charge high interest rates to derive returns as interest rather than dividends.
- The capital base for RFR shield calculation is determined at a specific point in time, creating opportunities for taxpayers to temporarily inflate their capital base.

Conclusions on Norwegian-style DIT

4.4.63 A DIT system with a Norwegian-style shareholder model provides a coherent framework for managing the company–shareholder boundary that could enhance revenue flexibility while maintaining competitive company tax rates. The system's automatic treatment of above-normal returns, integrated approach to capital gains, and elimination of lock-in effects offers significant advantages over other integration methods.

4.4.64 However, the challenges related to risk treatment, avoidance issues, and implementation complexity would need to be carefully assessed if such a system were to be considered for New Zealand. These considerations would need to be weighed against the benefits in terms of improved integration, neutrality, and revenue flexibility.

4.5 Conclusion

4.5.1 New Zealand's income tax is based on the concept of a comprehensive income tax. While a real-world income tax will always differ from the idealised base of a comprehensive income tax, leading to inevitable distortions particularly in the allocation of savings, there are some choices available to New Zealand to better align the income tax with the idealised concept.

4.5.2 New Zealand taxes a more limited set of capital gains than many OECD countries. This can give rise to equity and efficiency issues and creates challenges to raising substantially more revenue through the income tax. There are, however, difficult trade-offs with a CGT and the appropriate scope of capital gains taxation depends on balancing several factors. While a CGT would reduce opportunities for income sheltering and reduce distortions in the allocation of savings, capital gains taxes create costs through lock-in and provide a penalty on risk-taking. Capital gains taxes can also have relatively high compliance costs. More comprehensive taxation of capital gains

could however provide a meaningful increase in revenue to address long-term fiscal pressures.

4.5.3 Regarding company and personal taxation, consideration of revenue adequacy and economic costs suggests that there are good reasons for the company tax rate to be lower than top personal rates. However, this creates complexities and opportunities for individuals to reduce their tax liability. Options to improve this in the current system will only result in partial integration of the personal and company systems. DIT is an alternative approach to income tax design that is deliberately designed to allow differences in the company and personal rates. The Norwegian shareholder model provides an approach to manage shareholder–company integration in a non-aligned system.

Chapter 5 – Consumption tax

Overview

This chapter centres on consumption taxes. Given the focus of this LTIB on addressing long-term fiscal pressures, this chapter discusses possible enhancements to the consumption tax, or associated mechanisms, that may make it more flexible to changing revenue needs over time.

New Zealand's GST provides an efficient base from which to gather revenue. However, because it is set at a flat rate relative to expenditure and is not a progressive tax, if the rate were increased this may give rise to concerns about the impact on lower-income households and on poverty. Without effective mechanisms to address these concerns, future governments may discount using GST to raise revenue or there may be pressure to narrow the GST base.

This chapter looks at alternative approaches to making consumption taxes more distributionally responsive should the rate of the tax be increased. This chapter first looks at alternative designs of consumption taxes that have been proposed in the literature that allow for progressivity by considering individual circumstances, such as direct expenditure taxes. These systems, however, come with several practical complexities. Therefore, Inland Revenue considers that a value-added tax (VAT) remains the most appropriate consumption tax base for New Zealand.

Value-added taxes are a ubiquitous choice for consumption tax. Many countries exempt certain goods and services from the VAT base to meet progressivity goals. However, many studies have shown that GST exemptions are not a cost-effective way to target social assistance to low-income households compared to transfers. This is because, while lower-income groups may benefit relatively more as a proportion of income from GST exemptions, higher-income households will often receive a larger absolute benefit.

Recently, several countries have implemented GST-offset schemes as part of their GST/VAT. These schemes cushion the impact of a GST increase on low-income households by providing a credit to a target group of households. An example of such a scheme is Canada's goods and services tax/harmonized sales tax (GST/HST) credit, which is a quarterly payment to families with low and modest incomes to offset some of the GST/HST they pay.

This chapter and accompanying Analytical Note also investigate the potential effectiveness of a GST low-income offset mechanism for New Zealand. Our modelling shows that such an approach can be broadly effective in insulating low-income families from a GST rate increase at modest fiscal cost but highlights that there are difficult trade-offs between targeting precision and implementation simplicity.

5.1 Scope of chapter

5.1.1 The focus of this chapter is on using consumption taxes as a potential way to address long-term fiscal pressures should revenue needs rise. Chapter 3 discussed why there are good reasons to continue with a consumption tax as part of the tax system of the future. Consumption taxes can sit alongside either a general income tax (GIT) or a dual income tax (DIT).

5.1.2 However, a key issue is that because New Zealand's GST is applied at a flat rate to expenditure, increases in the GST rate could affect families in poverty, which may not be consistent with future governments' distributional goals. Therefore, this chapter centres on whether consumption taxes can be designed in a way that is more distributionally responsive, particularly in response to a rate increase.

5.1.3 This chapter proceeds as follows. Section 5.2 discusses key concepts and how we define a consumption tax. Section 5.3 discusses the broad options for the design of consumption taxes, including looking at alternative forms of progressive consumption taxes that take greater account of individual circumstances. This section concludes that a VAT is likely to continue to be the best choice of main consumption tax for New Zealand. Section 5.4 looks at the pros and cons of alternative ways to reduce the effect of an increase in the rate of GST on low-income families, including looking at exemptions and a low-income GST offset scheme. Section 5.5 concludes.

5.1.4 This chapter addresses general consumption taxes and does not cover specific consumption taxes, such as excises and duties.

5.2 Key concepts

5.2.1 Chapter 2 covered in detail what economic factors are taxed by a consumption tax. It showed that indirect taxes on consumption (such as value-added taxes like GST) are equivalent to a tax on labour income and economic rents. Further, consumption taxes may result in a tax on some forms of existing wealth when introduced or if the rate is increased. The key distinguishing feature of a consumption tax from an income tax, therefore, is that it leaves the normal, or risk-free, return to savings untaxed.

5.2.2 This equivalence also means that a consumption tax could be levied "directly" by taxing income less savings. This is called a direct expenditure tax (DET). A DET could allow for the economic base of taxation to be consumption while allowing for the use of progressive marginal tax rates that take account of individual circumstances. In some countries retirement savings contributions are not taxed when earned as labour income and returns from such savings are not taxed as earned, therefore approximating a consumption tax.

5.2.3 The economic efficiency arguments in favour of consumption taxes were discussed in Chapter 3. These arguments make consumption taxes an attractive channel to raise revenue should that be needed. One argument is that by not taxing the risk-free return to savings, consumption taxes do not distort choices as to when to consume or when to

work. That is, consumption taxes are neutral as to the timing of consumption. Prior chapters also discussed some of the practical difficulties in implementing an income tax, including in being able to measure income and tax it as it is earned. From a practical point of view, it can be easier to apply a consumption tax broadly, which can support efficiency and equity.

5.3 Options for consumption taxes

5.3.1 There are three broad options for a consumption tax:

- value-added tax (VAT)
- retail sales tax (RST), and
- direct expenditure tax (DET).

Value-added tax

5.3.2 Value-added taxes, such as New Zealand's GST, are a popular choice for taxing consumption and are found in more than 170 countries worldwide, contributing towards a significant amount of tax revenue in each jurisdiction. Reasons cited for their popularity include their capacity to raise revenue, alongside their perceived efficiency and neutrality (De la Feria & Swistak, 2024).

5.3.3 VAT is an indirect consumption tax. It is applied at each production stage of a good or service with the intent to tax the value-add of each business in the chain. The value-added element is measured by calculating the difference between the firm's sales revenue and the cost of purchased inputs.

5.3.4 There are two methods for calculating the value-added component under VAT, the credit-invoice method and the subtraction method. The credit-invoice method is more commonly used (and is used in New Zealand). Under this method, a credit against tax payable on an output is provided for the tax on inputs of a good or service thereby ensuring only the value-add is taxed at each step in the chain. This is recorded in invoices issued by the seller to the buyer.

5.3.5 Alternatively, there is a subtraction method, used exclusively in Japan to offset VAT. This method involves assessing the difference between the firm's taxable sales and its purchases of taxable goods and services. The tax is then charged to the difference.

Retail sales tax

5.3.6 RST is also an indirect consumption tax. It aims to tax the same consumption as VAT but faces different administrative and avoidance challenges. Unlike VAT, which is collected at each stage of the supply process, RST is collected at the final stage only. This reduces the costs of collection by ensuring that the earlier production processes are unencumbered by the compliance costs of paying the tax.

5.3.7 However, one advantage of spreading the collection points throughout the production process, such as the case with VAT, is that total avoidance requires a chain of bad

actors. For example, each actor in the chain will only be able to claim the correct input tax credit if the earlier producer in the chain has paid the VAT.

5.3.8 Furthermore, while both taxes aim to leave production efficiency unimpeded by taxing final consumption and not business profits, RST appears to face design challenges to prevent that from happening. The US and Canada demonstrate that the cost of RST often falls on businesses and in fact business is a significant part of the sale tax base (Mikesell, 2014). A study by Bird and Smart (2016) on the shift of consumption tax from retail sales tax to harmonised national VAT in some provinces in Canada in the 1990s showed an increase in investment in plant and machinery of 12.2% above trend following the reform.

5.3.9 In addition, while there is no reason that RST cannot apply to services, the US systems tend to apply to finished goods only, which leads to a narrower base than the New Zealand GST (although not necessarily other VAT systems with multiple exemptions).

5.3.10 Interestingly, RST rates are often lower than typical VAT rates; this may be because of avoidance concerns at the higher rates (Ebrill et al, 2001).

5.3.11 Indirect consumption taxes such as GST or RST are imposed at the firm/business level and therefore cannot be designed to apply a rate based on the level of income of the consumer as is the case with income tax. Options have been proposed in the literature (for example, Carroll & Viard, 2012) that would apply consumption taxes at the individual level at a progressive rate through using direct expenditure taxes. We look at one of these options next.

Direct expenditure tax

5.3.12 Under a DET, or cashflow consumption tax, income is taxed with a deduction for savings effectively resulting in the base being consumption. This would be equivalent to an indirect consumption tax if there were a single rate of tax because it leaves the risk-free return untaxed (this is shown in Box 7), but taxes labour income and economic rents. The key difference is that a direct consumption tax is targeted at the individual level (with businesses acting as withholding agents) and can therefore have progressive marginal rates based on individual levels of consumption, whereas an indirect consumption tax is imposed at the business level so is applied at a flat rate on consumption (with variation in rates based on the good or service rather than individual circumstances).

5.3.13 Since a taxpayer's measured consumption equals cash receipts minus savings outflows, the expenditure tax is a tax on net cash inflow during the year. Accrued capital gains would not be taxable although consumption from realised gains would be. Further, inflows such as loans received would be a cash receipt.

5.3.14 A DET could also be partially implemented by allowing a deduction for certain forms of savings such as retirement savings. This would, however, result in non-neutralities across different forms of savings.

Box 7: Example of cashflow DET

An individual earns $1,000 of labour income. In the first year they consume $800 and save $200. The savings generate a 4% normal return, and the individual withdraws $208 in year 2 (which is then consumed).

A cashflow DET of 20% applies to all cashflows (income less savings or investments). The effect is the same as an indirect consumption tax.

In year 1 tax of 0.2*($1,000 − $200) = $160 is charged, in year 2 the tax is 0.2*$208 = $41.60 (which has a present value of $40). The total present value of the tax as at year 1 is $200, which is the same as if all consumption had occurred in year 1 or if the normal return were not taxed.

5.3.15 There are several reasons direct expenditure taxes are proposed. First, is the standard argument to exempt the normal return from tax but to tax economic rents. Second, it allows for a consumption tax to be applied on a personal level with progressive tax rates so has more flexibility to meet governments' distributional objectives than VAT. Third, it avoids the difficulties of implementing a consistent approach to taxing capital income that plague a comprehensive income tax.

5.3.16 However, on designing an appropriate system, issues arise that suggest any such system will not be simple, and consequently the cashflow consumption tax has not been given serious consideration in practice. Some of the implementation difficulties (Weisbach, 2006) are covered in the following paragraphs.

5.3.17 First, progressive rates applied at the individual level can affect the present value of tax liabilities depending on the pattern of consumption. For example, in Box 7, if there was a tax-free threshold of $600 per year the individual could increase savings (and therefore reduce consumption) in year 1 so that no tax is paid in either period. The result would be a distortionary effect on consumption patterns, which undermines one of the fundamental efficiency properties of a consumption tax in providing inter-temporal neutrality. Solutions to retain inter-temporal neutrality involve systems to determine average annual consumption, which are complex and require individuals to have a high level of financial sophistication.

5.3.18 The inter-temporal neutrality of DET also requires taxpayers to expect constant tax rates between periods. If taxpayers anticipated that rates may change (for example due to fiscal pressures), this would result in inefficiencies through distorting the timing of consumption because consumers would shift the timing of consumption to take advantage of the different rates. Further, as discussed in Analytical Note 1 (Tax treatment of risk and lock-in), a DET with progressive rates will discourage risk taking in the same way as GIT with progressive marginal tax rates does.

5.3.19 Finally, the treatment of loans as cashflow "income" to finance consumption may be perceived as unfair to many, and, as with the case of variable tax rates solutions, are so complex as to mitigate the benefit of introducing the system in the first place.

5.3.20 Inland Revenue therefore considers a VAT has many advantages over a cashflow consumption tax.

Mixed direct and indirect expenditure taxes

5.3.21 Another option for taxing consumption is an approach that mixes aspects of indirect and direct expenditure taxation, such as the Hall and Rabushka flat tax or the X tax (these taxes have different rate schedules but are otherwise the same). These taxes start with a VAT and shift the taxation of wages from the business to the individual level. The X Tax was developed by David Bradford at the National Bureau of Economic Research. He calls the X tax a "two-tiered consumption tax" (Bradford, 1986). There are two aspects, first a cashflow business tax that operates as a consumption tax. Under this aspect all businesses (regardless of legal form) are liable for tax at a single rate with a deduction for payments to workers. Second, a graduated compensation tax (with a top rate at the business tax level) applied on individual effort. While this seems to have the same outcome as an income tax, the ability for businesses to deduct investment cashflows immediately combined with the fact that individuals are not taxed on investment income (only labour income) means that it retains the key feature of a consumption tax in not taxing normal returns.

5.3.22 The business tax is paid on all proceeds from goods and services with an immediate deduction for purchases of goods or services and investments. In a static tax environment, when business tax rates are constant, there would be no need to distinguish between capital and other purchases.[41]

5.3.23 Like a cashflow consumption tax, the advantages of X tax over the existing VAT come primarily from the ability to introduce progressivity. However, in a dynamic economy with changing tax rates the X tax must adapt in such a way (by introducing basis accounts for example) that mitigates that benefit and introduces complexity at an individual level that would intimidate the bravest of revenue authorities.

Conclusion: Consumption tax design

5.3.24 Given these practical considerations, Inland Revenue considers that VAT remains the most appropriate way to tax consumption in New Zealand. Next, we discuss New Zealand's GST and how to make it more distributionally responsive if GST were to be used to respond to changing revenue needs.

5.4 Using GST to respond to changing revenue needs

5.4.1 A summary of New Zealand's GST system is provided in the Introduction to this Part. There we noted that New Zealand's GST has a broad base by international standards. Broad bases support economic efficiency.

5.4.2 However, as GST has limited ability to take account of vertical equity goals, future governments may discount using it to raise revenue in the future. Chapter 1 noted that a progressive tax system does not require that every base be progressive, but as bases

[41] When business tax rates vary over time, Bradford suggests a depreciation type system with interest on outstanding tax written-down values to prevent distortion of capital investment, while retaining the economic character of the system.

get relatively large, distributional concerns relating to that base may become more pertinent. Here we look at mechanisms to couple a GST increase with distributional objectives. First, we discuss measures of the distributional effects of GST.

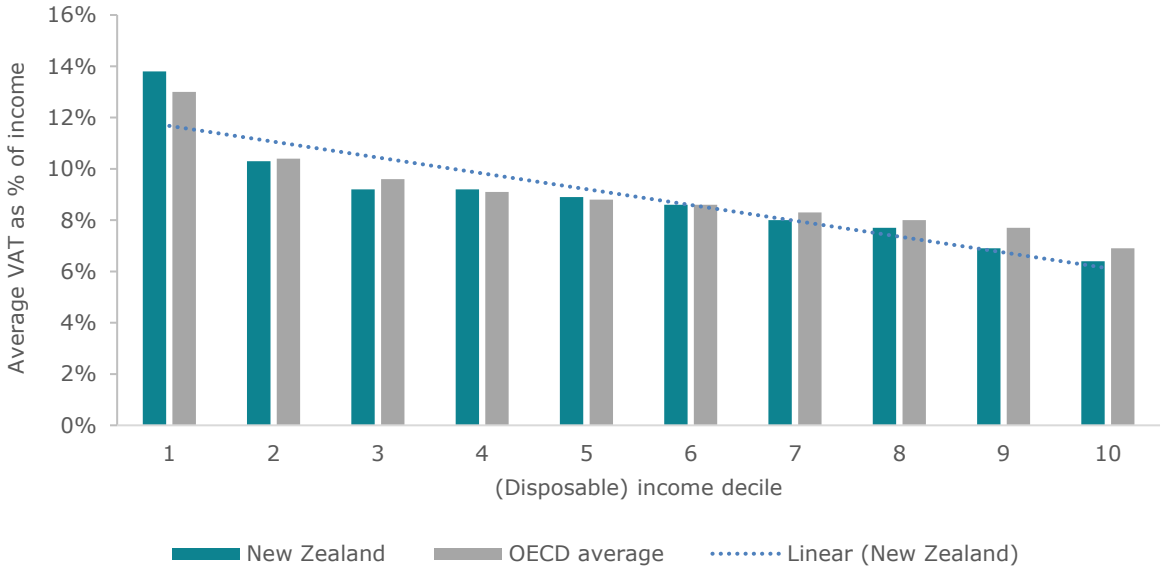
Measuring distributional effects of GST

5.4.3 The distributional effects of GST are often looked at by comparing the amount of GST paid to annual income or expenditure. However, as discussed in Chapter 1, there are conceptual difficulties in looking at GST relative to income. This is because in years when an individual has a high savings level, their consumption (and therefore consumption tax) will be low relative to their income, whereas the opposite will be true when they spend their savings. For this reason, the GST impost is often assessed relative to expenditure. Looking at GST relative to income versus GST relative to expenditure therefore gives different results.

5.4.4 Thomas (2020) assessed the distributional effects of VAT across OECD countries, relative to both annual income and expenditure. This study was completed using 27 OECD countries, including New Zealand (using 2015/16 Household Economic Survey (HES) data for New Zealand). Results are plotted for 10 disposable income deciles.

5.4.5 Assessing VAT relative to income, Thomas found New Zealand followed international trends where VAT is regressive relative to income. The OECD average VAT-to-income ratio declines from 10.4% in decile 2 to 6.9% in decile 10. New Zealand follows a similar trend with the ratio declining from 10.3% in decile 2 to 6.4% in decile 10.[42]

Figure 18: Average VAT as a percentage of income across income deciles



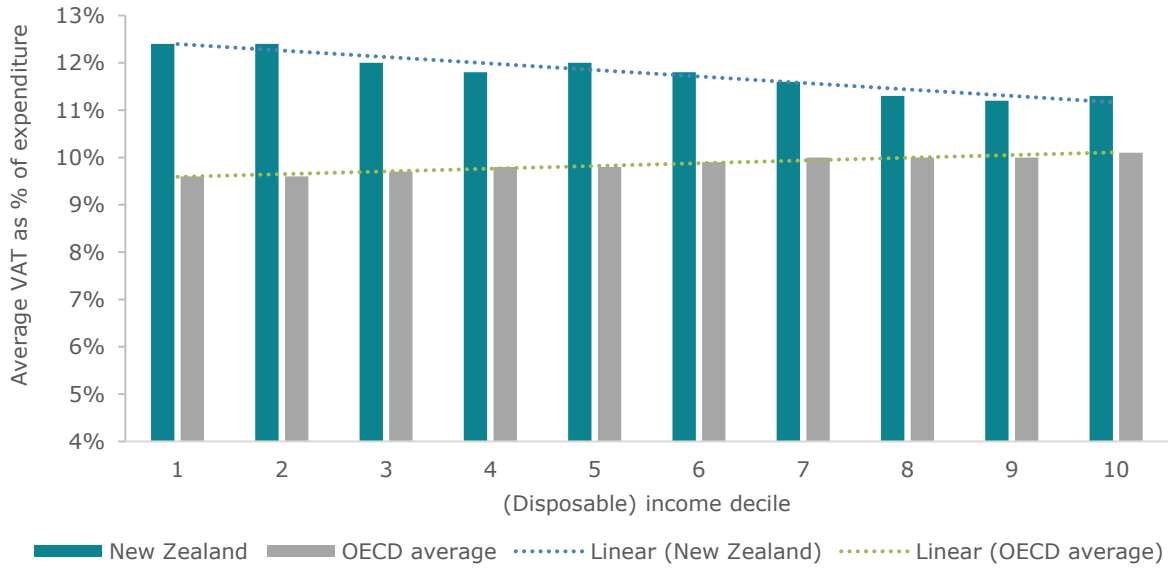
Source: Thomas (2020)

5.4.6 When VAT is assessed relative to expenditure (across income deciles), Thomas found VAT to be roughly proportional or slightly progressive for most OECD countries. This progressivity is due to the exemption of necessities from VAT, which often make up a

[42] We ignore decile 1 because it is not always a good measure of financial well-being.

large share of the consumption basket of lower-income households. For New Zealand, Thomas found the GST to be mildly regressive when assessed relative to expenditure suggesting some higher-income households spend a greater proportion of their total spending on the few items that are zero-rated or exempt in New Zealand.

Figure 19: Average VAT as a percentage of expenditure across income deciles



Source: Thomas (2020)

5.4.7 The expenditure analysis shows that exemptions can introduce a limited degree of progressivity into the VAT when considered relative to expenditure. However, we discuss in detail below how effective exemptions are relative to other options.

5.4.8 Thomas (2020) also assessed the effect of the VAT imposition on poverty by considering the effect of GST on those below the poverty line. He assessed the differences in poverty headcount, poverty gap, and squared poverty gap indices,[43] measured based on equivalised gross expenditure (including GST) compared to net expenditure (excluding GST).[44] Using HES Expenditure 2015/16 and gross expenditure as the base, he found that the imposition of GST in New Zealand increased the poverty headcount by 4.7%, the poverty gap by 1.7%, and the squared poverty gap by 0.8%, which are higher than the OECD averages of 3.1%, 0.7%, and 0.3% respectively.

5.4.9 This shows that whether GST is considered regressive or not, were the GST rate to be increased, the effects on lower-income households and poverty would be a significant issue to consider. As Thomas (2020) notes, "Assuming diminishing marginal utility of consumption, a proportional VAT will still have greater negative effect on the wellbeing of the poor than the rich. At the extreme, it may reduce the consumption of necessities by the poor, but merely (reduce) the consumption of luxuries by the rich". For this

[43] The poverty headcount is the percentage of the population living below a certain poverty line, the poverty gap shows the average income/expenditure shortfall from the poverty line (this shows how much GST further reduces expenditure below the poverty line) and the squared poverty gap index is the average of the square of the poverty gap ratio (squaring puts more weight on observations further below the poverty line).
[44] In this study, the poverty line is set at 50% of median gross expenditure.

reason, the next section looks at ways to reduce the effect of a GST rate increase on low-income households.

Options to reduce effect of VAT increases on low-income households: Exemptions versus low-income offsets

5.4.10 There are two broad ways that a VAT increase could be coupled with other measures to reduce the effect on low-income households:

- Exempting, or providing lower rates for, certain goods and services that form a large part of the consumption basket of lower-income households.
- Using cash transfers to offset the effect of a GST increase on lower-income households.

5.4.11 This section discusses the relative pros and cons of these two approaches.[45]

5.4.12 Internationally, it is common for lower VAT rates to be applied to different types of goods and services that are considered necessities. For example, certain foods are often taxed at a lower or zero rate. The purpose of these lower rates is to reduce the burden of the VAT on lower-income households. It may also be to encourage consumption of what is considered a "good".

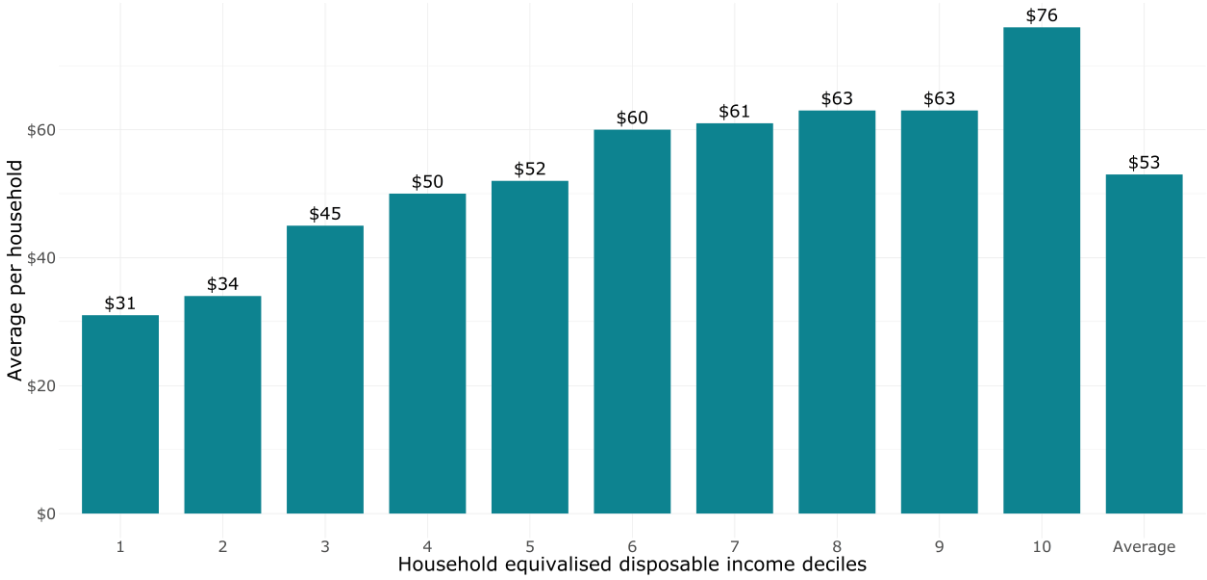
5.4.13 As noted, exemptions can make the VAT, as a proportion of expenditure, progressive. However, there are several downsides to this approach (Crawford et al, 2010).

- First, exemptions benefit everyone that consumes those goods or services. While lower-income groups may benefit relatively more as a proportion of income, higher-income households will often receive a larger absolute benefit. This is illustrated in Figure 20, which shows the average benefit per household income decile[46] of exempting food from GST based on HES expenditure data (2022/23). It shows higher income households would receive a greater benefit in dollar terms. In this way, exemptions are poorly targeted at supporting low-income households because the same amount of money given as a cash-transfer could provide more targeted support to low-income households.
- Second, exemptions introduce boundary issues, which mean that goods that intuitively should not benefit from exemptions may be included (certain foods for example). These boundaries can also lead to significant compliance and administrative costs.
- Finally, VAT exemptions (or reductions) are unlikely to be fully passed through to the consumer. As Chapter 1 notes, studies (Benedek et al (2020)) have found that pass-through to consumers for reduced VAT rates is lower than for standard rates.

[45] Personal tax rate reductions could also be used to offset a GST rate change. This may be particularly relevant if the aim is a revenue neutral change. However, it is hard to target personal tax rate changes especially when the change is not revenue neutral, and the goal is to assist low-income households. In that circumstance transfers are likely to be more effective and hence this is the second option we focus on.

[46] Household income is equivalised by the mOECD equivalence scale to account for household composition.

Figure 20: Average household weekly GST on food by household income decile



Source: Household Expenditure Survey (2023)

5.4.14 The relative cost-effectiveness of transfers over exemptions in supporting low-income households is supported by several empirical studies. Thomas (2015) considered the effect of adopting the UK's multi-rate VAT system in New Zealand. He found that adopting this system would have a progressive effect – with low-income/expenditure households seeing a larger percentage reduction in their GST burden than high-income/expenditure households. However, he also found that high-income/expenditure households gained more in absolute dollar terms supporting the fact that exemptions are not the most cost-effective way of targeting low-income households. Thomas (2020, 2022) finds similar effects.

5.4.15 These results are consistent with Ball et al (2016), which found that introducing a zero rate of GST on food would provide a greater absolute benefit to higher expenditure households. IMF (2014) also examines the effectiveness of fiscal redistribution mechanisms and supports that when comparing cash transfers to indirect methods, such as exempting goods from GST, transfers provide a more cost-effective approach.

5.4.16 These studies show that transfers or tax credits are a more cost-effective way to reduce the impact of a VAT increase on low-income households than the introduction of exemptions, although the effectiveness of the transfers depends on their design.

Design of tax credits to offset GST increase

5.4.17 This section looks at how GST low-income offsets have been designed in practice and applicability to New Zealand.

GST offset schemes used in other countries

5.4.18 Some countries have GST reimbursement schemes targeted at low-income households:

- **Canada** perhaps has the programme of most direct relevance to New Zealand. Canada has a goods and services tax/harmonized sales tax (GST/HST) credit, which

is a quarterly payment to families with low and modest incomes to offset some of the GST/HST they pay. This payment is based on adjusted family net income and family situation, automatically calculated when taxes are filed.

- **Singapore** has a permanent GST Voucher scheme aimed at supporting low- and middle-income households with their expenses, particularly what they pay in GST. This includes cash payments, MediSave top ups, community vouchers and rebates. In addition, the Assurance Package is on top of this scheme and was aimed at cushioning the impact of a 2% GST increase (Singapore Government).
- **Thailand's** Government introduced a VAT reimbursement scheme that delivers benefits on State Welfare Smartcards. From November 2018 to April 2019, all Smartcard holders were reimbursed 5% of the 7% VAT rate from purchases made on the card itself (Fenochietto & Benítez, 2021). Cardholders either met qualification criteria set by the Ministry of Finance, were unemployed or low-income earners. The total VAT reimbursement allowed was limited to 500 baht per month (approximately NZ$25).

5.4.19 Durongkaveroj (2022) finds that the Thai program did not fully alleviate the pressures faced by low-income individuals from VAT. This was principally due to the one-off registration for Smartcards, but studies also suggest the design of the card did not adequately target or reach the intended population.

Applicability to New Zealand

5.4.20 GST increases in New Zealand in the past have been accompanied by other changes to tax settings. In 2010, New Zealand increased the GST rate from 12.5% to 15% as part of a broadly fiscal neutral tax reform package that changed the balance of the tax mix from income taxes to GST. The GST rate increase was accompanied by reductions in personal income tax rates and the company tax rate. Benefit rates were increased to compensate for the price impacts of the GST rise. The distributional effect of this compensation package was discussed in advice by officials (The Treasury, 2010), although subject to significant assumptions and data limitations. While the intent of the tax reform was to change the tax mix, the Cabinet paper noted that it would not be the case that all people in all circumstances would be better off. It was noted that when, for example, people were spending significantly more than they were earning, an increase in GST would have left them worse off, at least in the short term.

5.4.21 In Analytical Note 2 (Distributional impact of low-income GST offset schemes) we assess potential options for a low-income offset scheme for New Zealand. The modelling highlights some of the trade-offs between targeting precision and implementation simplicity in designing a GST-offset scheme.

5.4.22 In this note we undertake a modelling experiment where the GST rate is increased by 3 percentage points (to 18%). We estimate that a 3-percentage point increase in the GST rate would have raised around $5.5 billion in revenue in tax year 2022–23. We investigate the impacts of various designs of a GST credit targeted at low-income families.

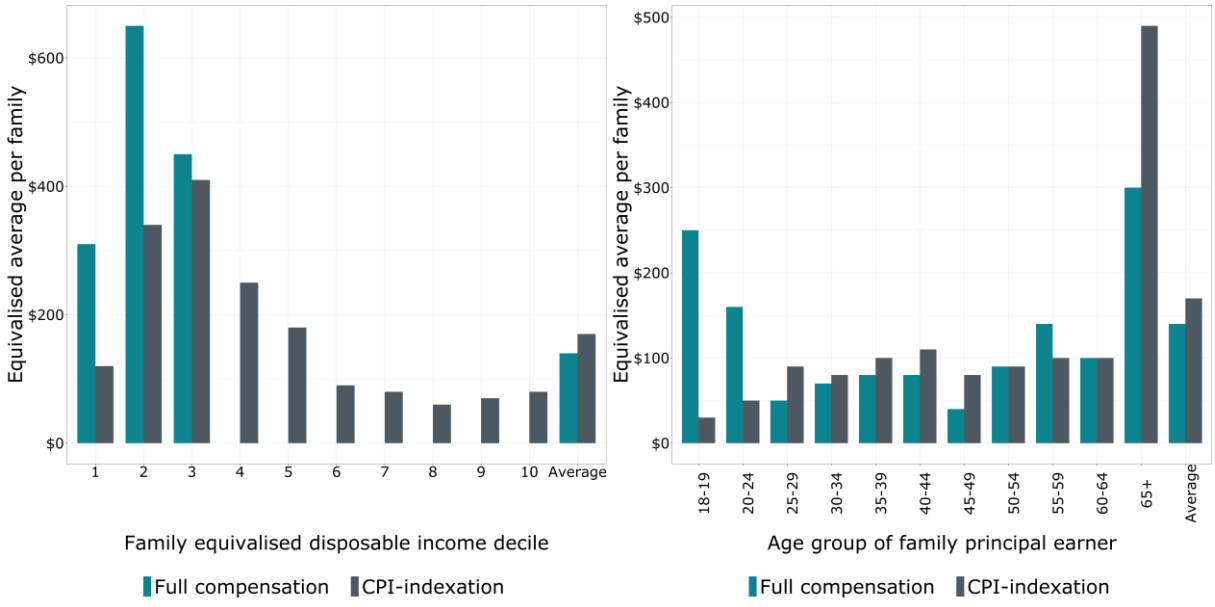
5.4.23 We first investigate a GST credit that fully compensates a target group of low-income families for the increase in GST they bear. For this experiment, we define low-income

families as families whose disposable income falls below 60% of median family disposable income (on an equivalised basis). This threshold would provide the credit to 26% of families in the population. On average a family in this target population would bear an additional amount of $650 in GST per annum (on an unequivalised basis) due to the GST rate increase. We estimate a credit targeted at this group of families, that fully compensates them for their GST increase, would cost around $.44 billion – or 8% of the gross revenue gain. The net revenue gain would therefore be around $5.1 billion.

5.4.24 Under current law, some benefits and New Zealand Superannuation are automatically indexed to inflation or average wages. A 3-percentage point increase in the GST rate would result in an approximate increase in the consumer price index (CPI) of 2.3%. We estimate that indexation of primary benefits for this inflationary impact would cost around $0.57 billion, or about 30% more than the targeted credit under the full-compensation approach.

5.4.25 Compared to the full-compensation approach, the CPI-indexation approach would compensate many families with higher income, such as higher income superannuitants, and is therefore less targeted at only supporting those on low income. The CPI-indexation approach, as opposed to the full-compensation approach, would also provide a higher level of compensation to the 65+ age group, on average (as most of this age group receive the benefit through indexation of superannuation) and a lower level of compensation to younger age groups. This is shown in Figure 21.

Figure 21: Average compensation in full-compensation and CPI-indexation scenarios



Source: Inland Revenue estimates

5.4.26 In sum, our analysis shows that a targeted, income-tested GST offset:

- Can insulate low-income families from a GST increase at modest fiscal cost.
- Can be better targeted at low-income families than relying on benefit indexation or exempting goods and services.
- Creates trade-offs between targeting precision and implementation simplicity.

5.5 Conclusion

5.5.1 There are many reasons to consider using GST to meet increased revenue needs:

- the broad base of GST makes it a relatively efficient tax
- the GST base does not have the same measurement issues as the income tax base
- a flat rate consumption tax does not provide a penalty to risk-taking, and
- increasing revenue through GST means that the tax rate on normal returns would not be increased.

5.5.2 However, the key concern with using GST to meet higher revenue needs is that it could have a relatively large effect on the wellbeing of low-income families. This chapter looked at the effectiveness of exemptions versus low-income offsets in insulating low-income families from a GST increase. Inland Revenue concludes that low-income offsets are a more cost-effective mechanism. Some other countries, such as Canada and Singapore have formally implemented GST low-income offsets schemes.

5.5.3 Our modelling suggests that a GST-offset credit targeted at low-income families can insulate low-income families from a GST increase at a modest fiscal cost. However, there are difficult trade-offs between targeting precision and implementation simplicity in designing a low-income offset scheme.

Chapter 6 – Alternative bases

Overview

This chapter discusses the pros and cons of adding alternative bases to New Zealand's tax system. It focuses on payroll taxes, wealth taxes, inheritance taxes, and land and property taxes. It also touches briefly on social security contributions, stamp duties and corrective taxes. It considers the efficiency and equity effects of these bases relative to existing bases, and in doing so, it explores what underlying economic factors they tax.

Payroll taxes are a tax on the labour income of employees – although at times they may also tax the capital income of self-employed workers and elements of labour income will be untaxed. For a given level of revenue, GST and income tax have some advantages over payroll taxes. GST is better at targeting labour income. It also taxes economic rents and acts as a lump sum tax on some forms of existing wealth if the rate is changed, which are efficient factors to tax. Income tax is better at taxing according to ability to pay.

Wealth taxes are equivalent to a tax on capital income that exempts above-normal returns. A broad income tax is likely to have important advantages over a wealth tax. This is because, for a given level of revenue, a wealth tax taxes normal returns at a higher rate than an income tax and, as discussed in Chapter 3, there is controversy about whether it is appropriate to tax normal returns at substantial rates. The non-taxation of above-normal returns may also contribute to wealth taxes seeming less vertically equitable than income taxes. Wealth taxes also face significant practical challenges, notably around asset valuation and taxpayer liquidity.

The effect of inheritance taxes depends on the motives of donors. If someone works and saves with the intention of leaving their wealth when they die, then inheritance taxes are a tax on labour and capital income and are likely to create similar distortionary costs to an income tax. But if someone intends to consume their wealth themselves but dies before they can do so, inheritance taxes are likely to impose lower distortionary costs than income tax. The equity effects of inheritance taxes are complex. The horizontal equity effects depend on whether they are viewed from the perspective of donors or recipients. In terms of vertical equity, they can be considered to reduce relative wealth equality or increase equality of opportunity.

Land taxes are a very efficient form of taxation given the fixed supply of land. They are a lump sum tax on those who own land when the tax is introduced. Property taxes and stamp duties are less efficient. Our research into the potential vertical equity impacts of land taxes in New Zealand suggests that liabilities would increase as incomes increase. Land taxes are likely to be seen as horizontally inequitable, given the incidence on existing landowners, and would have significant impacts on certain groups. This chapter explores some of the effects for Māori using He Ara Waiora policy framework.

Social security contributions (SSCs) are levied on workers' remuneration but entitle the payer to a social security benefit, such as superannuation. Individualised SSCs can have similarities to compulsory savings schemes. In New Zealand, SSCs have similarities with KiwiSaver.

6.1 Scope of chapter

6.1.1 This chapter discusses the pros and cons of adding alternative tax bases to New Zealand's tax system, if income tax and GST continue to be New Zealand's main bases.

6.1.2 The question of whether it makes sense to add an alternative base to the tax system could be considered in the context of both current revenue needs or if revenue needs substantially increased:

- At current revenue needs, there is a question of whether adding an alternative base while reducing revenue from existing tax bases would have beneficial efficiency or equity effects.
- If revenue needs increased, there is a question of whether the best way to meet those higher revenue needs, in terms of efficiency or equity effects, is by adding an alternative base or increasing revenue from existing bases.

6.1.3 However, as noted in the Overview, Inland Revenue considers that the best strategy to meet changing revenue needs over time is to have a stable core structure of main tax bases that comprehensively taxes the factors sought to be taxed, and to meet changing revenue needs by adjusting tax rates on those bases rather than by adding new bases. If the stable core structure comprehensively taxes those factors, then the desirability of an alternative base would not depend on the level of revenue. This approach would also ensure that tax bases are reasonably stable over successive governments. This means the key question in considering whether it makes sense to add an alternative base is how that base compares to existing bases in terms of its efficiency and equity effects, regardless of revenue needs.

6.1.4 This chapter proceeds as follows. Section 6.2 provides a framework for what to consider in adding a new base to the tax system. Sections 6.3 to 6.7 assess a set of alternative tax bases against this framework. Section 6.8 briefly touches on corrective taxes. Section 6.9 draws some conclusions.

6.2 Framework

6.2.1 A good way to compare alternative bases to existing bases is to examine the efficiency and equity effects from raising a given level of revenue from each. Every base is likely to have both positive and negative effects, so it is important to compare the net effects of raising a given amount of revenue from a particular base with the net effects of generating the same amount of revenue from other bases. If the net effects are more favourable for an alternative base than for existing bases, it may make sense to add the alternative base to the core structure and reduce revenue from existing bases.

6.2.2 In considering the net effects of bases, it is important to consider how the efficiency and equity effects of a base trade-off against each other. Even if an alternative base has high efficiency costs relative to existing bases, adding the base might help a government meet its overall objectives for the tax system if the base has particularly high equity benefits relative to existing bases. Equally, if an alternative base has weak

equity benefits relative to existing bases, adding the base might still make sense if it improved the overall efficiency of the tax system.

6.2.3 Understanding the efficiency and equity effects of bases requires consideration of what underlying economic factors they tax. As discussed in Chapter 3, the taxation of some factors may impose higher efficiency costs or may align more closely with certain distributional or equity goals than the taxation of other factors. Chapter 3 also explained that there is an in-principle case on revenue sufficiency, efficiency and equity grounds for having a tax system that taxes labour income under a main base, taxes normal returns but potentially at lower rates than labour income, and taxes economic rents at similar rates to labour income.

6.2.4 To understand efficiency effects, consideration also needs to be given to administration and compliance costs. Each base has its own fixed administration and compliance costs, so adding an alternative base is likely to increase those costs relative to raising additional revenue from existing bases. We therefore need to consider whether the administration and compliance costs of an alternative base outweigh the benefits of adding the base.

6.2.5 Given these considerations, the following sections examine alternative tax bases in terms of their efficiency and equity effects relative to existing bases. In doing so, we consider what underlying economic factors are taxed by these alternative bases.

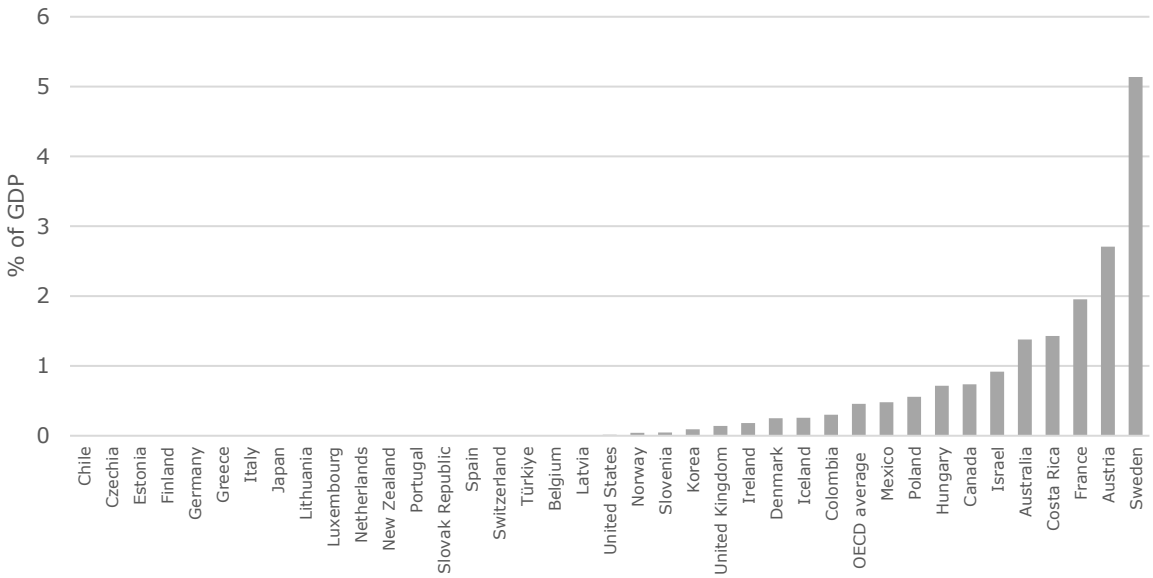
6.2.6 We focus on the alternative bases of payroll taxes, wealth taxes, inheritance taxes, and land and property taxes (including stamp duties on property transfers). We have chosen to focus on these bases because we consider they could be explored by future governments as options to raise revenue or address distributional concerns. Payroll taxes are common in other OECD countries. Wealth and inheritance taxes have been widely discussed in recent years as potential ways to make tax systems more progressive. Land and property taxes are also common across the OECD, and land taxes were supported by a majority of the 2010 VUW Tax Working Group as a way of funding reductions in New Zealand's other taxes. We also briefly consider social security contributions and corrective taxes. The first have similarities to payroll taxes and the latter were suggested by several submitters to our consultation on the scope of this LTIB as an alternative way of raising revenue in the future.

6.3 Payroll taxes

Background

6.3.1 Payroll taxes are levied on the remuneration of employees and, at times, the self-employed. They may be levied on the employer or employee, but in either case the incidence is likely to largely fall on the employee (see paragraph 1.3.20). Around half of the OECD member countries had payroll taxes in 2022, as can be seen in Figure 22 below. These taxes raised an average of 0.5% of GDP across the OECD, and a high of 5.1% of GDP in Sweden.

Figure 22: Payroll tax revenue as a percent of GDP, 2022



Source: OECD (2025)

6.3.2 New Zealand does not have a payroll tax and has never had one in the past.

6.3.3 Many countries also levy taxes similar to payroll taxes known as social security contributions (SSCs). These are also levied on employees' remuneration but, unlike payroll taxes, they confer a future entitlement to social security benefits. New Zealand currently has an SSC in the form of the ACC levy, which helps pay for the costs of recovery from accidental injuries. The levy raised 1% of GDP in 2022. New Zealand also used to have an SSC that helped pay for the costs of unemployment relief, but this was abolished in 1969. SSCs are explored further in Box 8.

Effects

6.3.4 Payroll taxes tax the underlying economic factor of labour income. Relative to New Zealand's existing bases, they therefore overlap with GST and income tax, which also tax labour income. If a future government wanted to change the tax mix by shifting the balance of taxation away from capital income and toward labour income, then one option to do this would be to add a payroll tax.

6.3.5 In theory, payroll taxes only tax labour income. In practice, however, they may also tax some capital income if they are levied on self-employed workers. In this case, part of self-employed workers' income may be capital income (compensating a self-employed worker for the opportunity cost of capital invested in their business) as well as part being labour income. It may be difficult, if not impossible, to distinguish the capital income and labour income components (Milanez & Bratta, 2019). It would be possible to levy payroll tax on the incomes of self-employed workers at a lower rate to take account of the fact that some of this income would often be capital income. However, this would under-tax those whose remuneration has a large labour income component. It would also create incentives for work to be done through self-employment contracts

rather than employment contracts. Payroll taxes are also unlikely to tax all labour income. For example, as noted in Chapter 4, international literature (Advani et al (2024)) has found that labour income can be captured in capital gains. As a result of these complications, payroll taxes are unlikely to be a very targeted way of taxing labour income.

6.3.6 For a given level of revenue, GST is likely to have some key advantages over a payroll tax. First, GST taxes all labour income when that income is spent, so it does not face the same difficulties as a payroll tax in needing to define labour income. It is therefore a more robust way of taxing labour income. Second, unlike a payroll tax, GST taxes economic rents and acts as a lump sum tax on some forms of existing wealth when the rate is increased, which are efficient factors to tax.

6.3.7 For a given level of revenue, income tax may also have some advantages over a payroll tax. Income tax is likely to be better at taxing according to ability to pay. This is because, unlike a payroll tax, it taxes economic rents, which are an additional gauge of ability to pay alongside labour income. In addition, it can easily apply progressive tax rates across a worker's total income when they have more than one job. Under a payroll tax with progressive rates, however, the marginal rates applied in each job may not reflect a worker's total income. If this happens, a worker with more than one job will have a lower average tax rate than a worker earning the same total income from just one job.

6.3.8 As with all taxes, the detailed design of payroll taxes would have specific efficiency and equity effects. In Australia, state payroll taxes are levied based on employers' total wage bills and include tax-free thresholds. The 2009 review of Australia's tax system estimated that these taxes had relatively high efficiency costs because of the effect of the tax-free thresholds on business size. The review noted that similar payroll taxes with no thresholds would have much lower costs (Henry et al, 2009).

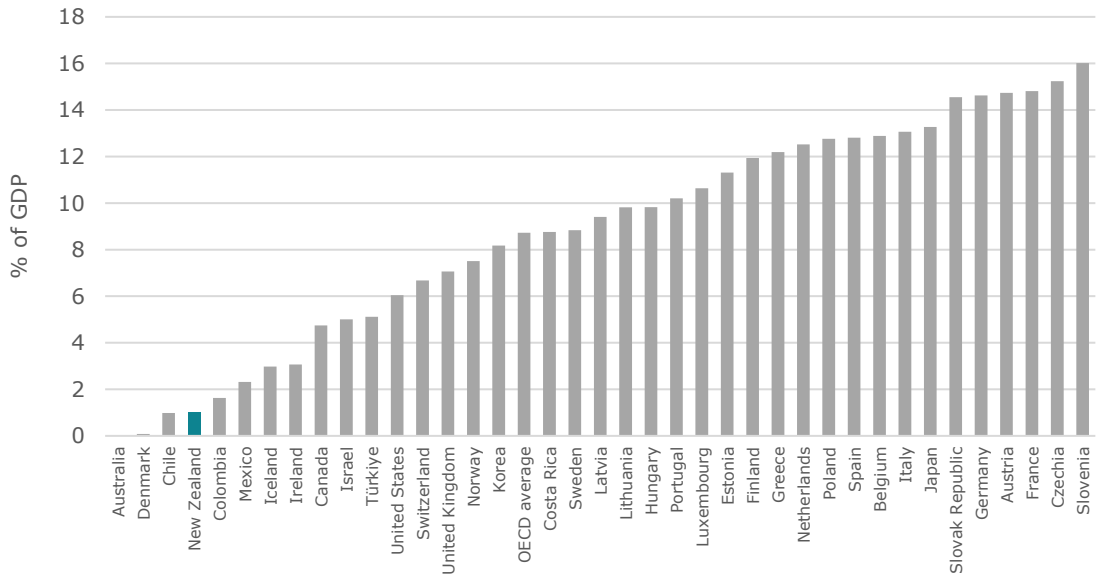
6.3.9 In Box 8 below we look at SSCs. Note that in Figure 23 in Box 8 we have adjusted the figure for New Zealand to include revenue raised in New Zealand by the ACC levy. Although the levy meets the OECD's definition of an SSC, the OECD do not include it in their data for New Zealand to ensure consistency with countries that have compulsory work-related private insurance to cover accidents and occupational diseases.

Box 8: Social security contributions (SSCs)

As noted above, SSCs are like payroll taxes in that they are levied on workers' remuneration. They differ in that, in general, the payment of SSCs entitles the payer to receive social security benefits, such as for healthcare, superannuation or unemployment insurance. The revenue generated by SSC payments is often (but not always) ring-fenced to fund the cost of these benefits.

Almost every OECD country had a form of SSC in 2022, as can be seen in Figure 23. SSCs raised nearly 9% of GDP on average across the OECD. In most OECD countries, SSCs are a much more important source of revenue than payroll taxes. In 2022, only two out of the 38 OECD countries raised more than 2% of GDP in payroll taxes, while only five countries raised less than 2% of GDP in SSCs.

Figure 23: SSC revenue as a percent of GDP, 2022



Source: OECD (2025)

There is an element of redistribution in some SSC systems, in that some taxpayers receive more SSC-funded benefits than the amount they pay in SSCs, while others receive fewer benefits. In other systems there is no redistribution, and individual taxpayers receive benefits in proportion to the amount they pay in SSCs – in other words, the benefits are "individualised".

In general, SSCs raise similar efficiency and equity considerations to payroll taxes. Individualised SSCs provide an exception to this, however, because they are less like a general revenue-raising tax and more like a mechanism to require people to save for their private costs. The distortionary costs of individualised SSCs may be lower than those of other taxes, because individual taxpayers' SSC payments are, in effect, returned to them when they receive their benefits. This also means that for individualised SSCs to be an option for addressing fiscal pressures, they would need to be accompanied by a reduction in spending on related social security benefits such as superannuation.

In the New Zealand context, an individualised SSC that was ring-fenced to superannuation spending would overlap with KiwiSaver, raising the question whether requiring KiwiSaver contributions for certain people would be a better route to take than implementing a new mechanism through an SSC.

6.4 Wealth taxes

Background

6.4.1 Wealth taxes are levied on net wealth (assets minus liabilities). They typically apply to the worldwide net wealth of residents and to the net wealth held by non-residents within the taxing country.

6.4.2 Wealth taxes have become less common across OECD countries over time. An OECD study published in 2018 noted that the number of member countries levying wealth taxes on individuals fell from twelve in 1990 to four in 2017 (OECD, 2018). One of those four countries (France) has subsequently repealed its wealth tax. Of the remaining three countries, only one (Switzerland) raised more than 0.5% of GDP from wealth taxes in 2022.

6.4.3 New Zealand has never had a wealth tax, although it has had taxes on wealth transfers in the past (see the following section on inheritance taxes).

Effects

6.4.4 Relative to New Zealand's existing main bases, wealth taxes most closely overlap with income tax. This is because, as discussed in Chapter 2, wealth taxes are equivalent to a tax on capital income – albeit one that exempts above-normal returns.

6.4.5 A broad income tax is likely to have important advantages over a wealth tax. This is because wealth taxes only tax normal returns, whereas income taxes tax both normal returns and above-normal returns such as economic rents. Therefore, for a given level of revenue, a wealth tax must tax normal returns at a higher rate than an income tax. As discussed in Chapter 3, while there is a strong case for taxing economic rents at substantial rates, there is more controversy about whether this is appropriate for normal returns. However, a broad income tax would include the taxation of capital gains and as shown in Box 6, even under a realised capital gains tax (CGT) there could be deferral advantages arising from capital gains taxation.

6.4.6 Wealth taxes can also be seen as less vertically equitable than income taxes. Consider two people who have the same amount of wealth, but one person earns a higher return from their wealth than the other person. Under an income tax, the person earning a higher return will pay more tax. Under a wealth tax, however, they will pay the same amount of tax.

6.4.7 In practice, wealth taxes are likely to face similar practical challenges to an idealised income tax that includes a tax on accrued gains, as discussed in Chapter 3. First, a neutral wealth tax would require real-time valuation of assets, which would be difficult for certain assets including those that are traded infrequently. This could result in relatively high administration and compliance costs. Countries with wealth taxes have attempted to address these issues by providing different options to value certain assets (such as property), by treating asset values as fixed for a given number of years, or by

exempting certain assets from the tax base. However, these approaches would tend to increase the risk of avoidance and reduce the neutrality of the tax (OECD, 2018).

6.4.8 Second, a wealth tax would give rise to liquidity issues because the tax liability would not necessarily be matched to taxpayers' cash flows. Taxpayers might therefore need to liquidate assets to be able to pay the tax. Countries have attempted to address this by placing a cap on tax liabilities as a share of income. For example, when France had a wealth tax, taxes on income could not exceed 75% of a taxpayer's total income, with any amounts over this threshold deducted from the wealth tax. Again, these provisions would tend to increase the risk of avoidance (OECD, 2018).

6.4.9 For wealth taxes to be progressive, they may need to be levied at progressive rates or include a tax-free threshold, rather than being levied at flat rates. This is because they tax assets that earn higher returns by the same amount as those that earn lower returns, and there is some evidence that those with more wealth hold assets that generate higher returns (see paragraph 2.4.16). Base narrowing can also make a wealth tax regressive if the wealthier are better able to arrange their affairs to take advantage of various concessions (OECD, 2018).

6.4.10 There has been international interest in applying wealth taxes with high tax-free thresholds, so the tax only applies to very wealthy individuals. For example, US senator Elizabeth Warren has proposed an "Ultra-Millionaire Tax", which would apply to household net wealth between US$50 million and US$1 billion. An existing example of this is Spain's wealth tax, which has a tax-free threshold of €700,000. Potential reasons for such a design are:

- If governments wanted a more progressive tax system, a wealth tax on very wealthy individuals could be a way to increase average tax rates on those individuals without putting pressure on other parts of the tax system, for example, from widening the gap between top personal tax rates and the company tax rate.
- Applying a wealth tax only on very wealthy individuals might address some of the high compliance costs of a wealth tax mentioned above because these costs may be proportionally less burdensome for the very wealthy.

6.4.11 Another notable concern with wealth taxes is what effect they have on migration incentives. The international evidence on the effect of wealth taxes on mobility is limited (Kleven et al, 2020). However, there is likely to be a reasonable risk that adding a wealth tax to the tax system would make very wealthy residents more likely to emigrate and make very wealthy non-residents less likely to immigrate.

6.5 Inheritance taxes

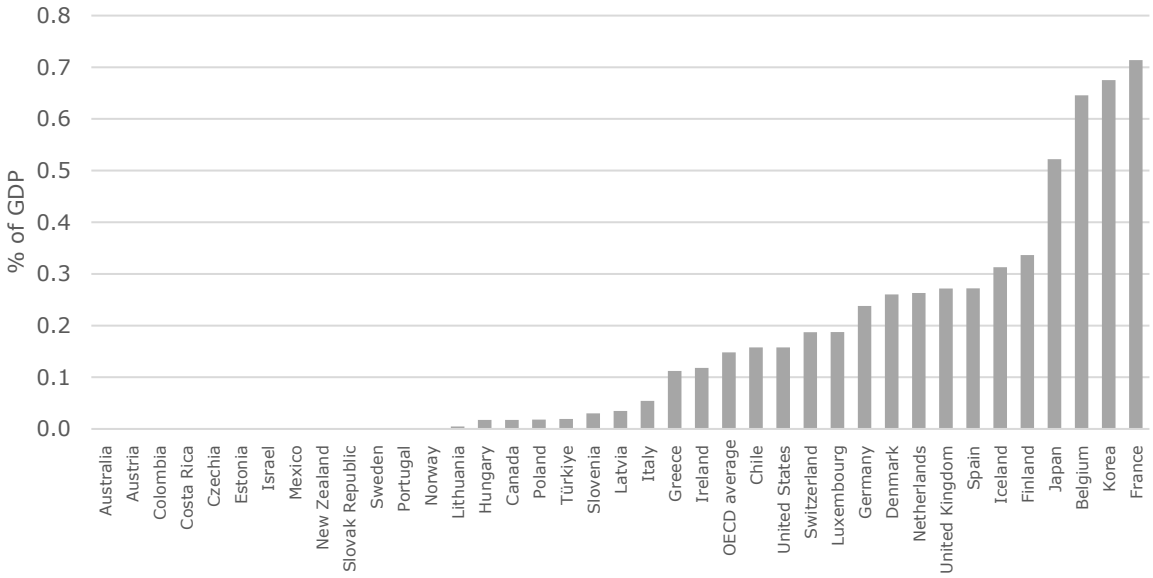
Background

6.5.1 Inheritance taxes are levied on wealth when it is transferred from a donor to a recipient at the time of the donor's death. They are levied either on the inheritance received by the recipient or on the estate bequeathed by the donor (the latter are commonly referred to as "estate taxes").

6.5.2 Inheritance taxes are often implemented in combination with gift duties, which are levied when wealth is transferred during the donor's lifetime. Gift duties are often implemented with the purpose of protecting against the avoidance of inheritance taxes.

6.5.3 In 2022, around two-thirds of OECD countries had an inheritance tax or a gift duty, as shown in Figure 24. These taxes raised an average of 0.1% of GDP across the OECD and a high of 0.7% in France and Korea. Given that many countries are experiencing ageing populations, revenue from these taxes could be expected to increase as a share of GDP in future.

Figure 24: Inheritance tax and gift duty revenue as a percent of GDP, 2022



Source: OECD (2025)

6.5.4 New Zealand does not currently have an inheritance tax but has done so in the past. A tax on estates was introduced in 1866, followed by a gift duty in 1885. These taxes raised more than 10% of central government tax revenue at their peak. The estate tax was abolished in 1993 and the gift duty in 2011.

Effects

6.5.5 The efficiency effects of inheritance taxes depend on the motives of donors. Some people are "intentional donors" – that is, they intend to leave at least some of their wealth when they die. For these people, inheritance taxes reduce their incentives to work and save to be able to leave an inheritance when they die. In this context, inheritances taxes are a tax on the underlying economic factors of labour and capital income. They can therefore be considered to overlap with the existing base of income tax and are likely to create similar distortionary costs.

6.5.6 However, other people are "unintentional donors" – that is, they intend to consume all their wealth themselves, but they die before they can do so. For these people, inheritance taxes have no effect on their incentives to work and save. In this context, inheritance taxes are likely to impose lower distortionary costs to income taxes.

6.5.7 There is limited evidence on the distortionary costs of inheritance taxes given the difficultly of establishing donors' motives. However, a 2021 paper by the OECD noted that the empirical literature generally shows inheritance taxes have negative but small effects on savings, and that the effects are smaller for inheritance taxes than for wealth taxes (OECD, 2021).

6.5.8 The administration and compliance costs of inheritance taxes should be relatively low in theory. This is because the information required to administer and comply with inheritance taxes is often already required for non-tax reasons, such as for the probate process. Costs are likely to be lower when taxes are levied on estates rather than inheritances because taxes on estates apply tax at only one point, on the disposal of the estate, whereas taxes on inheritances may apply tax at multiple points, depending on the number of people receiving inheritances.

6.5.9 In practice, however, inheritance taxes often feature preferential tax treatment for certain groups or situations, which would tend to increase administration and compliance costs. For example, 16 countries in the OECD provide preferential treatment to family-owned businesses, 12 countries do so for main residences, 10 do so for land or property used for agriculture or forestry, and 8 provide full exemptions for private pensions (OECD, 2021). Such treatment is likely to increase administration costs and create avoidance opportunities. It may also increase compliance costs if it increases the effort that taxpayers spend on determining what is inside and outside the tax base. And it is likely to increase distortionary costs because taxpayers will be incentivised to change their behaviour to receive the preferential treatment.

6.5.10 The horizontal equity effects of inheritance taxes depend on whether they are viewed from the perspective of the donor or the recipient. In the eyes of the donor, such taxes may be seen as inequitable because they place a higher tax burden on those who transfer their wealth when they die compared to those who consume their wealth while they are alive. In the eyes of the recipient, inheritances can look like an additional form of income. From this perspective, inheritance taxes could be argued to improve horizontal equity by taxing this apparent income alongside other types of income.

6.5.11 The vertical equity effects of inheritance taxes are complex. A number of studies have found that while inheritances increase the wealth of more wealthy individuals by a greater absolute amount than they increase the wealth of less wealthy individuals, they increase the wealth of less wealthy individuals by more relative to pre-inheritance wealth (Australian Productivity Commission, 2014). This means that inheritances have an equalising effect on the distribution of wealth. Inheritance taxes counteract this effect, increasing differences in relative wealth. On the other hand, the OECD considers that inheritance taxes contribute to taxation being levied on the basis of ability to pay, and that they can improve equality of opportunity by reducing the advantages some people receive from being born into a wealthy family (OECD, 2021).

6.6 Land and property taxes

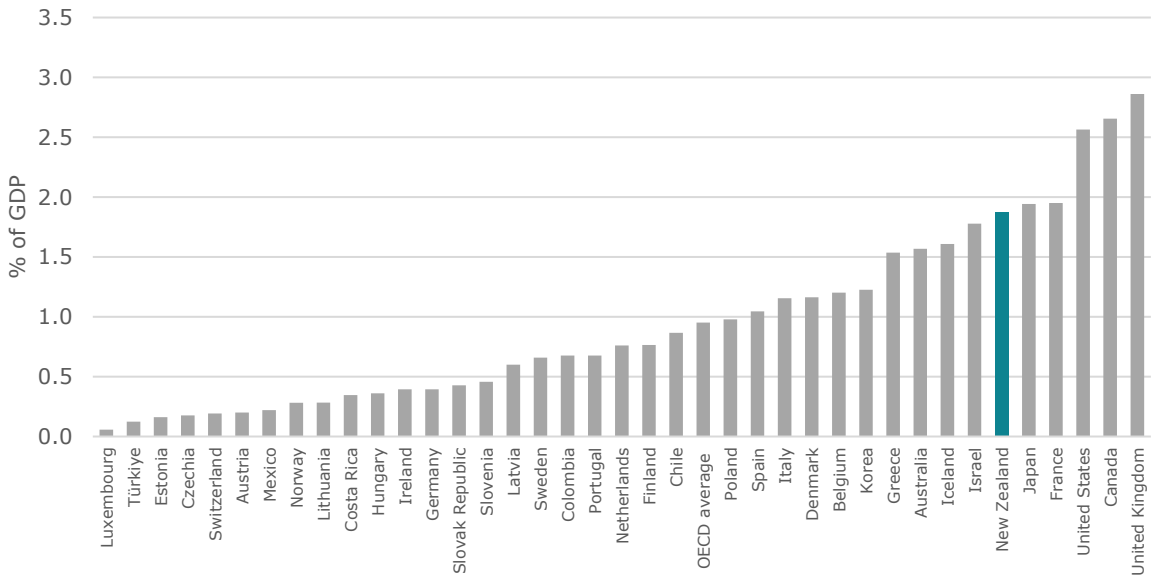
Background

6.6.1 Land taxes are recurrent taxes on the gross value of wealth from unimproved land. Unimproved land is the land without any improvements built into or onto it, that is, permanent structures such as roads, drainage pipes and residential buildings.

6.6.2 Property taxes are recurrent taxes on the combined gross value of unimproved land and improvements (sometimes referred to as the "capital value"). Land taxes are therefore a subset of property taxes.

6.6.3 As can be seen in Figure 25, every OECD country had land and/or property taxes in 2022. These taxes raised an average of 1% of GDP across the OECD and a high of 2.9% in the UK.

Figure 25: Recurrent taxes on land and/or property – tax revenue as a percent of GDP, 2022



Source: OECD (2025)

6.6.4 New Zealand currently has land and property taxes as part of its system of local government rates. As shown in Figure 25, these raised nearly 2% of GDP in 2022.

6.6.5 There are different types of local government rates, but those known as general rates can be based on land values (a land tax) or on capital values (a property tax). In 2019, 94% of local authorities applied general rates. Of these, 29% based their general rates on land values and 71% on capital values (Insight Economics, 2019).

6.6.6 New Zealand also had a land tax at the central government level, but this was repealed in 1990.

Effects

6.6.7 Land taxes are widely seen as one of the least distortive taxes (see, for example, VUW Tax Working Group, 2010 and the Mirrlees Review, 2011). This is because the supply of land is fixed, and therefore landowners cannot reduce the amount of land available in response to the introduction of a land tax. Instead, a land tax would be expected to cause the value of land to fall by a lump sum equal to the net present value of expected future land tax liabilities.[47] As a result, land taxes are a lump sum tax on those who own land when the tax is introduced.

6.6.8 Property taxes are likely to be more distortive than land taxes. This is because the supply of land improvements, such as buildings, is more elastic than the supply of land. The introduction of a property tax creates a disincentive to supply property, and because supply is elastic, less property is made available.

6.6.9 Property taxes are likely to be particularly distortive when they apply to commercial property. This is because commercial property is an input into the production process, and taxing production inputs distorts decisions that firms make about the production process, reducing production efficiency. Property taxes are likely to raise similar equity issues as land taxes but are suboptimal from an efficiency perspective so from here onwards we focus on land taxes.

6.6.10 Land taxes are likely to have low administration and compliance costs. This is particularly true in New Zealand, given that land ownership and values are already known and used for the purposes of local government rates. The physical and immoveable nature of land also makes it difficult to avoid such taxes, which helps keep administration costs low.

6.6.11 The vertical equity effects of land taxes are unclear. The OECD notes that property taxes might fall more heavily on middle-income households than high-income households in OECD countries, because middle-income households tend to hold a high proportion of their wealth in property relative to other, more lightly taxed assets, whereas high-income households tend to hold a lower proportion of their wealth in property relative to other assets (Brys et al, 2016).

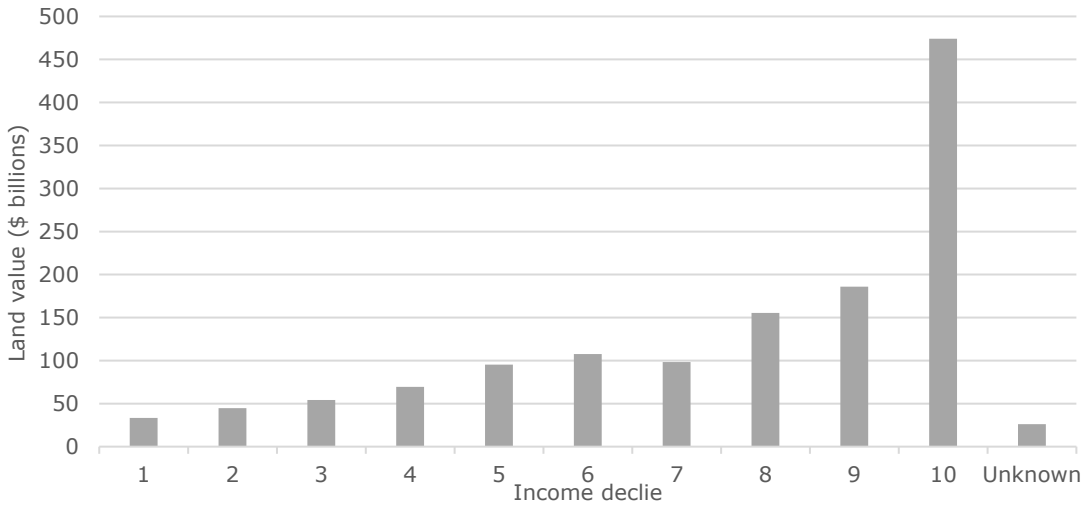
6.6.12 To get a better understanding of the vertical equity effects of land taxes in New Zealand, Inland Revenue has analysed data on land values collected by Land Information New Zealand and matched this to income data held internally. This analysis is explained in more detail in Box 9 below. In short, it suggests that land tax liabilities would likely increase as incomes increase.

[47] It may be difficult to verify this expected result empirically, however, because the expected reductions in land values might be muted by the effect of spending funded by a land tax, for example, if the funding raised was spent on improving infrastructure connected to land.

Box 9: Distributional effect of land taxes in New Zealand

Figure 26 shows Inland Revenue's estimate of the distribution of the value of land held across individual income deciles in New Zealand. It is based on taxable income data and calculations of the value of land owned by individual taxpayers. When land is owned by a company, it looks through the company structure and assigns ownership to the ultimate individual owners.

Figure 26: Distribution of land values by individual income deciles



The graph shows that the value of land holdings generally increases as incomes increase, with a significant increase in values in the highest income group. This indicates that land tax liabilities would increase as incomes increase. There is a slight decrease in land values in decile 7, which might be the result of income planning around income tax thresholds. The overall trend shown in the graph is consistent with findings from Inland Revenue's research project on high-wealth individuals, which found that the share of real estate holdings increases as net worth increases in New Zealand (Inland Revenue, 2023).

The results reflect several modelling assumptions that needed to be made given incomplete data. More information on the methodology used can be found in Analytical Note 3 (Property data), published alongside this LTIB. The results should also be considered in the context of the inherent challenges in measuring distributional effects discussed in Chapter 1.

6.6.13 Land taxes can be seen as horizontally inequitable in two key respects. First, they fall on those who own wealth in the form of land and not on those who own wealth in other forms. Second, they fall on those who happen to own land when the tax is introduced, and not on those who own land in the future. The choice of the introduction date therefore determines the incidence of the tax at the margins, and there may be few principled reasons for choosing one date over another.

6.6.14 Land taxes can also have a disproportionate effect on certain landowners:

- Asset-rich, cash-poor landowners: Land taxes do not take account of people's ability to pay the tax from their annual incomes. Asset-rich but cash-poor landowners (such as retirees) may therefore face cashflow difficulties in paying the tax. Some landowners may need to sell their land to be able to pay.

- Highly geared borrowers: The introduction of a land tax would reduce land values by the net present value of expected future land tax liabilities. This fall in land values might push highly geared landowners into negative equity.
- Land-extensive sectors: Land taxes would fall more heavily on those sectors that use large amounts of land, for example, farming and forestry. A 2009 paper estimated that the land values of farms in New Zealand were higher than those of residential properties across the income distribution, meaning that farmers would, on average, pay more land tax than residential property owners (Inland Revenue and Treasury, 2009).

6.6.15 The introduction of a land tax would also have significant implications for Māori, given that land is central to Māori identity and culture. Box 10 considers these implications using He Ara Waiora, a wellbeing framework developed by the Treasury in collaboration with Ngā Pūkenga that uses concepts derived from mātauranga Māori.[48]

Box 10: Implications of a land tax for Māori

To understand the implications of a land tax for Māori, it is first useful to acknowledge the historical and current context of Māori land ownership. In 1840, Māori owned almost all land in Aotearoa. Following the signing of the Treaty of Waitangi, the Crown obtained increasing amounts of land through acquisition and confiscation. Today, the proportion of land that is classified as Māori land[49] is around 6%.

Māori land ownership is governed under Te Ture Whenua Māori Act 1993, which puts restrictions and protections in place to facilitate the retention of land by Māori. The Act also seeks to facilitate the occupation, development, and utilisation of Māori land for the benefit of its owners, their whanau and their hapu. Despite these objectives, Māori landowners face many challenges in using and developing their land. For example:

- Māori freehold land often has multiple owners, sometimes numbering in the hundreds or thousands. This can make decision-making complex and time-consuming.
- Māori freehold land cannot be easily sold or used as collateral for loans. This can make accessing finance difficult.
- Māori freehold land may not have the potential to be utilised. A third of Māori freehold land is land-locked and 80% is in the non-arable class of land use.
- The legal and regulatory requirements for managing and developing Māori land can be burdensome and costly.

Next, it is useful to identify the aspirations that Māori have expressed about Māori freehold land. Ko Ngā Tumanako o Ngā Tāngata Whai Whenua Māori, a 2011 report by Te Puni Kōkiri, summarises the findings of several hui held with Māori landowners across Aotearoa to understand and articulate their aspirations regarding the use of Māori land. The report identified two key aspirations commonly expressed by landowners:

- *Retention*: Māori land should be retained, and cultural connections to the land (such as those arising through whakapapa) should be maintained and promoted.

[48] For more information on He Ara Waiora, see https://www.treasury.govt.nz/information-and-services/nz-economy/higher-living-standards/he-ara-waiora.

[49] Māori land refers to Māori freehold land, meaning land that has had its beneficial ownership determined by the Māori Land Court by freehold order; and Māori customary land, meaning land held by Māori in accordance with tikanga Māori.

- *Utilisation*: Māori land should be utilised as an expression of cultural responsibilities (such as kaitiakitanga), including around the use of the land for personal and commercial reasons.

Given this context, we can consider the potential effects of a land tax for Māori. He Ara Waiora directs us to consider these effects across three key quality-of-life determinants:

- *Wairua* – the foundational source of wellbeing. This can be understood as people feeling connected to something beyond themselves.
- *Taiao* – the natural world. In the context of land, this can be understood to refer to the capacity of land to support life.
- *Ira tangata* – the human domain. In the context of land, this can be understood to refer to the capacity of land to support people.

The effects of a land tax would ultimately depend on how the tax was designed, but in general it could be expected to:

- Increase pressure on landowners to use their land in a way that maximises financial returns, which could undermine their ability to pursue objectives such as promoting whakapapa and upholding kaitiakitanga responsibilities.
- Reduce land values, compounding difficulties that landowners face in accessing finance for development and reducing the value of redress provided by the Crown through Treaty settlements.
- Compound existing challenges related to the administration of and compliance with legislation, for example, due to information gaps on land values and ownership.

Overall, these effects could lead to further alienation of Māori land, resulting in cultural dislocation, economic hardship, social fragmentation and poorer environmental outcomes.

He Ara Waiora also provides a guide on how a land tax could be designed to minimise these effects. For example:

- The principle of *manaakitanga* could be considered to mean a land tax should be designed and administered in a way that responds to the inherent challenges Māori landowners face in using and developing their land. One way this could be achieved is by considering exemptions from the land tax for unused Māori land, consistent with similar exemptions from local government rates.
- The principle of *whanaungatanga* could be considered to mean a land tax should be designed and administered in a way that acknowledges the relationship that Māori have with Māori land. This could be achieved by adjusting the valuation of Māori land for land tax purposes to reflect the historical, cultural, legal and physical characteristics of the land.
- The principle of *tiakitanga* could be considered to mean a land tax should be designed and administered in a way that aligns with broader objectives. This could be achieved by alignment of the administration of land tax with wider administrative processes, such as for the payment of local government rates.
- The principle of *kotahitanga* could be considered to mean a land tax should be designed and administered in a way that reflects a joined-up approach across government. This could be achieved by ensuring a land tax was designed with input from agencies such as Te Puni Kōkiri, Land Information New Zealand and Te Arawhiti.
- The principle of *tikanga* recognises that Māori have a range of rights and interests in land, which the Crown has duties, under the Treaty of Waitangi, to protect. In the context of designing and administering a land tax, some of the most relevant views afforded by the Waitangi Tribunal and the courts create an expectation that decisions about the design of a land tax should be properly informed, aim to remove disparities, and are broadly supported by Māori.

6.6.16 In practice, concerns about the effects of land taxes on certain groups could lead to relief or exemptions from the tax being applied. These might be similar to relief provided under the system of local government rates. As noted above, certain types of Māori land can be exempted from local government rates, and a rates rebate scheme operates for low-income homeowners and certain retirement village residents. In Australia, states often apply exemptions from land tax to main residences, primary production land, retirement villages, caravan parks, and other categories.

6.6.17 However, the provision of such relief could create its own horizontal equity concerns on the part of those who remain subject to the tax. It would also increase efficiency costs by distorting taxpayer behaviour and adding administration and compliance costs.

6.7 Stamp duties

Background

6.7.1 Many jurisdictions – most notably the Australian states and several Asian economies – raise revenue from stamp duties (conveyance or transfer duties) on the purchase of real property, shares, or certain legal instruments. Revenues are typically modest and volatile because they depend on the volume and value of transactions. New Zealand levied stamp duty on land and other transfers until the late 1990s (Inland Revenue, 1999) but now uses only local government rates for recurrent property taxation.

6.7.2 A stamp duty is best thought of as a lump-sum charge on changing ownership rather than on the ongoing enjoyment or economic rent from land. Because the base is transactions rather than value, stamp duties do not comprehensively tax land rents in the way an annual land tax does, nor do they follow ability-to-pay principles as closely as income tax.

Effects

6.7.3 Relative to an annual land tax, which is regarded as highly efficient because the supply of land is fixed, a stamp duty on property transactions distorts household and business mobility. Potential buyers face a large upfront charge, so mutually beneficial moves are delayed or forgone. These "lock-in" effects are conceptually similar to the capital gains tax lock-in discussed earlier, but here they arise every time property changes hands.

6.7.4 Incidence falls largely on new entrants and existing owners who need to relocate (such as growing families, job movers), while long-term holders avoid the tax. This raises horizontal-equity concerns when otherwise similar households face very different lifetime tax bills depending on how often they move. Vertical equity effects are ambiguous; duties are progressive with respect to transaction size, but this might only be weakly related to ability-to-pay. The lock-in that stamp duties create can impede lower-income renters from becoming owners.

6.7.5 Collection is mechanically simple (paid through the conveyancing process) and has low evasion risk.

6.7.6 Compared with an *annual* land-value tax, introducing a stamp duty on property transactions would add a new base without materially broadening the tax mix. Stamp duties appear less compelling than either maintaining the status quo or exploring a modest broad-based land tax.

6.8 Corrective taxes

6.8.1 In response to our consultation on the scope of our LTIB, some submitters suggested we explore corrective taxes as a way raising revenue in future. In the summary of submissions document, we noted that corrective taxes are an important issue that requires its own in-depth analysis, and that could be the subject of a future LTIB. However, to round off our current discussion of alternative bases, we provide a brief analysis of corrective taxes here.

6.8.2 Corrective taxes are taxes that are primarily intended to change behaviour. New Zealand currently has some forms of corrective taxes, for example on alcohol, tobacco, fuel and waste disposal. Other countries have other forms of corrective taxes such as those on greenhouse gas emissions and sugar.

6.8.3 Corrective taxes are typically introduced for two main reasons: to actively discourage certain undesirable behaviours, or to address externalities and internalities.[50]

6.8.4 Corrective taxes address externalities, and potentially internalities, by changing prices so that individuals take more consideration of the costs that their actions impose on others and themselves. In doing so, corrective taxes reduce distortionary costs to the extent that they shift individuals towards more optimal levels of activity. However, it can be difficult to measure and calculate the value of externalities and, particularly, internalities, making it challenging to identify the appropriate level of tax for achieving optimal levels of activity. In addition, corrective taxes are often regressive because they tend to fall more heavily on lower-income individuals.

6.8.5 Corrective taxes will raise revenue if the activity being taxed continues. This might be desirable when society is willing to accept an ongoing level of activity. However, if the aim is to eliminate the activity, corrective taxes do not provide a long-term source of revenue.

6.9 Conclusion

6.9.1 This chapter explored some of the pros and cons of alternative tax bases relative to existing tax bases in New Zealand's tax system.

6.9.2 In sum, payroll taxes provide a means of shifting the balance of taxation away from capital income and onto labour income, but they are likely to have some disadvantages relative to GST and income tax. Wealth taxes are likely to impose higher distortionary

[50] Externalities are the costs that an individual imposes on others without their consent. Internalities are the costs that an individual imposes on themselves without having a full appreciation of those costs.

costs than a broad-based income tax, and they face similar challenges to those that would make an idealised income tax that includes accrued capital gains impractical. Inheritance taxes are likely to have similar distortionary costs to income taxes when people are intentional donors, but they will have much lower distortionary costs when people are unintentional donors. Land taxes are widely seen as one of the least distortive taxes, and they impose fewer distortionary costs than property taxes or stamp duties. However, they would have a significant impact on certain groups. As with any tax, providing preferential tax treatment to certain groups or in certain situations would tend to increase efficiency costs and reduce horizontal equity on some margins. For New Zealand, SSCs to fund superannuation would have overlaps with KiwiSaver.

6.9.3 This analysis shows there are difficult trade-offs involved in all alternative bases. This underscores the importance of the main bases of income tax and consumption tax being designed in a way that is as efficient and fair as possible while having the flexibility to adjust to changing revenue needs.

Chapter 7 – Increasing flexibility – conclusions

7.1.1 The key focus of this LTIB has been on how to create a durable tax system in the face of fiscal pressures due to the ageing population. We have argued that while future governments will have choices over how to manage these fiscal pressures, New Zealand will have greater fiscal resilience if the tax system has the flexibility to easily adapt to changing revenue needs over time. In the context of potentially higher revenue needs, this means having the ability to raise higher levels of revenue without imposing undue efficiency or equity costs. A focus has been on increasing the ability to raise rates on the main bases of an income tax and GST should revenue needs increase.

7.1.2 In this chapter we summarise key insights from Part 2.

Income tax

7.1.3 Chapter 4 discussed two key constraints on the tax system's ability to raise higher levels of revenue from the income tax base.

- **Comprehensiveness of the income tax base**: The absence of a general approach to taxing capital gains can provide an incentive for individuals to reduce their tax liability by undertaking activities that are not taxed rather than those that are taxed. This can reduce government's ability to raise more revenue in a way that is progressive.
- **Integration of company and personal taxation**: Less than full integration of the personal and company tax regimes provides an incentive for individuals to shelter income in companies. This incentive is likely to increase the wider the gap between top personal tax rates and the company rate, however, in the context of rising fiscal pressures, a system that *requires* alignment of the company rate and top personal rate is unlikely to be a durable tax system.

7.1.4 Inland Revenue has assessed options to reduce these constraints within the current income tax system. This included considering the case to tax more capital gains and options to improve the integration of the personal and company tax regimes. The case for taxing more capital gains requires weighing different considerations in terms of impacts on revenue adequacy, equity, efficiency and compliance and administration costs. While there are opportunities to enhance the integration of the company and personal regimes under our current system, none will lead to full integration and fully eliminate incentives to retain income in companies to reduce tax liabilities.

7.1.5 Given this, Chapter 4 also considered if the flexibility of the income tax system could be increased by moving to a dual income tax system. In general, this system is designed to enable different rates to apply to labour and capital income while reducing incentives to shelter income in companies. However, a dual income tax would be a major system change, and it would have its own challenges particularly from implementation complexity.

GST

7.1.6 In Chapter 5, we discussed the pros and cons of using GST to raise more revenue, should that be required. The key constraint is that, as GST is set at a flat rate relative to expenditure, rate increases can have a significant impact on low-income households. Therefore, depending on their distributional goals, future governments may discount using GST rate increases as a way of raising higher levels of revenue.

7.1.7 There are options to reduce the effect of a GST rate increase on low-income households. Exemptions or lower rates could be provided for certain goods and services that form a large part of the consumption basket of lower-income households. Alternatively, cash transfers to low-income households could be used to offset the effects of a GST rate increase.

7.1.8 There are several downsides to the first approach. Exemptions are a poorly targeted option for supporting low-income households, they introduce boundary issues that can significantly increase administration and compliance costs, and they are unlikely to be fully passed on to end consumers. Cash transfers are a much more cost-effective approach, although there can be trade-offs between targeting precision and implementation simplicity.

Alternative bases

7.1.9 In Chapter 6, we discussed alternative tax bases that could be added to the tax system to raise revenue. Other OECD countries raise considerable revenue from taxes that New Zealand does not have, such as payroll taxes, broad social security contributions, wealth taxes, inheritance taxes and land and property taxes at the central government level. These bases each have their own pros and cons that would need to be considered when weighing up the case for adding a particular base.

7.1.10 However, as noted in Chapter 6, if it makes sense to add a base at higher revenue needs, it likely makes sense to have that base as part of the tax system at all levels of revenue, and to reduce revenue from other bases as needed. This underscores the focus of this LTIB on a durable tax structure being one with a stable core structure, with flexibility to adjust to changing revenue needs.

Future focus

7.1.11 Given this analysis, Inland Revenue considers that a key focus for further work to ensure New Zealand's tax system is durable in the face of long-term fiscal pressures is to give more in-depth consideration to modifications to the income tax or GST regimes that may make these regimes more flexible to changing revenue needs.

7.1.12 We are interested in submitters views on which options discussed in this document show most promise. Some questions for submitters are set out on page 9.

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