Capital gains: it's time we joined the rest of the OECD

Kathy Spencer

The Labour Party has been trying to broaden the taxation of capital gains since 1967. There have been multiple expert committees, and a range of proposals, but none has made it to the implementation stage.

While we have procrastinated, other countries have long since moved ahead, making us an outlier in the OECD. Capital gains have been taxed in the UK since 1965, in Canada since 1972, and in Australia since 1985.

The strongest argument for the taxation of capital gains is one of fairness. The tax system should apply equally to all taxpayers, regardless of how they earn their income. People earning wages and some interest on their savings, for example, are taxed on every dollar. On the other hand, people with assets like rental properties or shares, are able to earn tax-free income when assets are sold.

In New Zealand, 70% of assets, excluding owner-occupied homes, are owned by the wealthiest 10% of households. So, when capital gains on those assets are left out of the tax system, the wealthy benefit out of all proportion to the rest of the population.

Looking to Australia, 72% of capital gains were earned by the top 10% of income earners in 2014. In the US it is more extreme, with 90% of capital gains being earned by the top 10% of earners in 2015.

The second strong argument is that the quality of investment improves when the tax system treats alternative investments even-handedly. For example, failure to tax profits on the sale of rental properties encourages investment in that sector at the expense of productive businesses wanting to grow.

One of the sticking points with taxing capital gains is how to deal with the impact of inflation. When an asset increases in value, part of the increase compensates for inflation and does not make the owner better off. Ideally, this component would not be taxed.

Many countries address this by taxing capital gains at a reduced rate, or by taxing only a proportion of the capital gain.

An alternative is to use an indexation system to take the inflation component out of both taxable income and expenses. Labour developed a comprehensive indexation system in 1989 as part of a proposal to bring capital gains into the income tax base.

Australia used indexation in a limited way to calculate taxable capital gains in the period 1985 - 1999. It then simplified its system by dropping indexation and taxing 50% of capital gains instead.

For both the 2011 and 2014 elections, Labour opted to campaign on a capital gains tax at the reduced rate of 15%.

More recently, the Tax Working Group, chaired by the late Sir Michael Cullen, put forward a proposal in 2019 to significantly expand the list of capital gains that are taxed as income in New Zealand. The Group's interim report acknowledged there was a strong case in principle for inflation adjustment, but went on to argue that nothing should be done about it.

The gains were to be measured only from the date of implementation, and taxed when the asset was sold. The family home, and personal-use assets like cars and boats, were to be excluded.

But taking away the lucrative tax break for capital gains was always going to be met with some resistance. As Sir Michael said at the time:

"Any tax system creates large vested interests that will oppose change. Any change to a tax system is easily misrepresented as a tax grab, an ideological lurch, unfair, unworkable or all of these."

Unfortunately, very little effort went into making the case for change and explaining how gains would be taxed. As a result, many people were scared-off by the misinformation spread by some commentators - for example, that middle income earners would be the most affected, rather than the wealthy.

The debate got away from the government and an excellent opportunity to fix a long-standing problem was lost.

Showing admirable persistence, the Labour Party has now put the tax treatment of capital gains back on the table and is having an internal debate on the subject. While the issue is far from simple, the groundwork has already been done and there are many overseas models to draw from.

For a proposal to be acceptable, in my view it will need to deal with inflation. Options include using an indexation system, or aligning with Australia by treating 50% of capital gains as taxable income.

Whatever Labour decides on, there needs to be good information for the public explaining the need for change, who would be impacted, by how much, and what would be done with the additional revenue.

Although Labour has made all the running on capital gains so far, our Prime Minister must surely be aware of the glaring inequity when wage earners are taxed on every last dollar of their incomes, while many wealthier New Zealanders enjoy tax-free capital gains.

National also prides itself on being a good economic manager. By any standard, that includes having a tax system that treats alternative investments even-handedly.

Moving to broaden the taxation of capital gains would improve the fairness of the tax system and the quality of investment, while raising additional revenue for the rather long queue of public services in need of more funding.

After 57 years of mulling it over, it's time for either National or Labour to bring New Zealand into step with the rest of the OECD.

Kathy Spencer is a former tax policy manager in the Treasury, a deputy-director general in the Ministry of Health, and a general manager in ACC.