

Opinion: An alternative to a capital gains tax which will remove housing market distortions

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By Andrew Coleman



If you wander through central Auckland and try and spot the people on the highest tax rates, the chances are you'll get it wrong.

It's not the young man in the sharp suit earning \$150,000 or the well dressed lawyer going about her business. Rather, it's the soon-to-retire woman earning \$5,000 interest on top of her \$35,000 salary, because lending money is the most highly taxed activity in New Zealand.

This is because the government taxes the inflation component of interest payments. If you lend \$1,000 at 7% when the inflation rate is 2%, \$20 of the \$70 interest is to compensate you for inflation because what cost \$1,000 a year ago costs \$1,020 now. Only \$50 is real earnings.

Nonetheless, the government taxes the full \$70 rather than the \$50 real interest. Since someone on a 33% tax rate pays \$23.10 of the \$70 in tax, their true rate of tax on the \$50 real earnings is 46.2%. Despite all the talk of tax reform in recent weeks, little has been said about how odd it is to tax people simply because the government inflates away the value of their money.

The problem is worse the higher the inflation rate or the lower the interest rate. In the last decade, when interest rates averaged 6 percent and the inflation rate averaged 2.6%, the tax on real interest income was 75% higher than the tax on other types of income. It is little wonder investors are attracted to residential property, for capital gains are tax free.

Moreover, if landlords borrow to finance their investment they are allowed to deduct the full nominal interest payment as an expense even though inflation is eroding the value of the debt. So not only does the tax system penalize lenders when there is inflation, but it rewards borrowers.

One way to create a more level playing field would be to introduce a capital gains tax. But an alternative proposal, which has been little discussed, is to exempt the inflation component of interest income from tax. Quite simply, if you earned 7% when the inflation rate was 2%, you would only pay tax on the 5% real earnings. Conversely, you would only be able to deduct real interest payments when calculating taxable income.

A level field would be creating by removing a tax instead of introducing an additional one.

The traditional case to exempt the inflation component of interest earnings from tax has been based on fairness. Not only is the inflation component of interest not income, but this "not-income" is received largely by older and less-sophisticated investors. It is not for nothing that the tax applied to it is sometimes called the widows' tax.

In addition to being unfair, recent economic analysis suggests the interaction of inflation with the tax system is the root cause of low home ownership rates among younger households. Quite simply, the excessive taxation of interest income (and the excessively generous deductibility of interest payments) makes it more profitable for wealthy middle-aged households to become landlords than it is for them to lend money to would-be owner-occupiers.

The effect becomes larger as real interest rates fall, possibly explaining the recent increase in the number of people becoming landlords.

The modeling suggests that exempting the inflation component of interest income from tax will have very similar effects on the housing market as introducing a capital gains tax. In both cases, homeownership rates would rise, in part because rents would increase, and the additional saving would improve the country's net foreign debt position.

At first glance, this idea might seem crazy at time of large government deficits. Isn't the whole point of a tax to raise revenue? Wouldn't eliminating the tax on the inflation component of interest significantly reduce revenue? Surprisingly, the answer is "No".

Currently, little revenue is raised from the tax on the inflation component of interest income, because for every dollar of tax paid by a lender, a large number of cents are claimed as deductions by an investor. The Inland Revenue Department doesn't have good estimates of the net amount of tax collected or rebated, but it is unlikely to be much, and could be negative.

If the idea isn't crazy, why hasn't it been done? Largely, it would seem, for two reasons. First, there is a widespread perception that "low" inflation isn't a big problem. This may be correct — unless you lend money, in which case even low inflation can increase effective tax rates by 75 percent.

Secondly, it may be difficult to implement a tax system that only taxes real interest earnings. This may also seem surprising, since it would appear relatively simple to subtract the inflation rate from the nominal interest rate at the end of the year, and mail out an inflation-tax rebate to lenders.

But tax experts have identified many complications, such as the tax treatment of financial contracts that are hybrid loan/equity products. More importantly, inflation distorts other aspects of the tax system, particularly the way that firms are allowed to depreciate capital assets.

Currently, each year firms are allowed to claim part of the cost of an asset as a cost of doing business, using the historic cost of the capital. Because the replacement cost of capital assets typically rises with inflation, firms' profits are overstated, and thus they too are over-taxed. This means inflation can reduce capital investment — unless firms are indirectly compensated in another manner, in this case by deducting the inflation component of interest payments from their income. Any move to tax real interest income would eliminate this deduction, and perhaps lead to a reduction in investment.

The accepted wisdom in tax circles is that the inflation component of interest income should not be exempted from tax unless depreciation allowances are also corrected for inflation. Put more bluntly, the cost of ensuring businesses are not penalized from our inability or unwillingness to index the tax system for inflation is the excessive taxation of lenders.

Is it really impossible to index the tax system for inflation? Not all people think so. A former Governor of the Reserve Bank, Ray White, strongly advocated the indexation of the tax system. The 1989 "Consultative Document on the Taxation of Income from Capital" by the then Minister of Finance (David Caygill) thought it would be feasible to index the tax system "without imposing excessive compliance and administrative costs."

A comprehensive review in the United States came to a similar conclusion, noting the most difficult part would be the indexation of capital gains for the purpose of calculating capital gains tax liability.

In recent years, Government officials have made repeated calls for people to save more. Currently they are looking for bold measures to improve the way we tax ourselves, notably to remove the distortions in the housing market. But rather than look for new taxes, perhaps they could seek to address both problems by eliminating a tax — the tax on the inflation component of interest income.

It is simpler to do in New Zealand than anywhere else in the world precisely because we don't have a capital gains tax. And not only would it remove distortions in the housing market, it would end the ridiculous situation that lending money, the simplest way of saving, is the mostly highly taxed activity in New Zealand.

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There are several papers on this topic on the [Motu website](#). The two most relevant papers are called "[Tax, credit constraints and the big costs of small inflation](#)", and "[The long term effects of capital gains taxes in New Zealand](#)".