Tax Working Group
Te Awheawhe Tāke

**Tax Working Group Information Release**

**Release Document**

**September 2018**

**taxworkingroup.govt.nz/key-documents**

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12 April 2018

# Tax Working Group – background paper – The Concept of Income

## Introduction

I was asked by the Group to provide a paper on the concept of income. This is in response to that request but it is more in the nature of a note or letter. It is not an academic piece and does not source external material. It is based on my observations over the years and just reflects my thinking.

The Canadian Carter Commission of the 1960s advocated a capital gains tax for Canada on the basis that "a buck is a buck". The idea here is that income is income irrespective of the form it crystallises as in the hands of the income earner. Capital gains are income and should be taxed as such under an income tax. This has been frequently cited in support of taxing capital gains and has obvious merits. The point of this note is that it is not such a clear cut concept. Income can mean different things when viewed from different perspectives. What is a "buck" to me may not always be seen by another person as a real "buck" especially in a different context. While this does not negate the Carter Commission point, it caveats it. To say that capital gains is income in an economic sense is generally true but that is not by itself a conclusive argument for taxing such gains as income.

The view of this note is that there is no simple or clear answer as to what is income. There are various forms or definitions of income none of which is unambiguously right or wrong. It depends on context and the purpose the term is being used for.

Forms or definitions of income include:

- The Haig-Simons economic definition of income
- Other economic interpretations of income
- Accounting income
- Capital income versus labour income
- Household versus personal income
- Social income (the income of society as a whole versus the income of only an individual or household)
- Real versus nominal income
- Income in one currency or another based on spot or forward exchange rates or purchasing power parity
- The average person's intuitive view of what is income
- Annual versus lifetime income

Each can be relevant depending on the context. Nor is any concept usually applied in practice in a pure way. This is not only for practical reasons but also because it often makes no sense to do so – theory and good policy are not necessarily the same.

Policy analysis needs to consider taxing or not taxing items that could be included in a tax base and apply judgement and wisdom as to the costs and benefits of taxing that item or not – it is not simply a matter of determining whether an item is income under one definition and taxing accordingly.

It is for this sort of reason that it is often argued that only the risk free rate of return on capital income should be taxed even though that does not accord with concepts of income outlined in this note. That is because (provided losses are useable) taxing gains in excess of the risk free rate merely means the investor has less risk and the government has more. It is argued that there is no fairness or efficiency benefit in taxing such income and the government revenue is in a sense fictitious being merely reflective of the increased risk the government is assuming. Equally an analysis of the effects of taxing items of income is argued to mean that the government should have very high rates of tax on location specific economic rents. On an ongoing basis taxing such rents does not alter behaviour and can be said to have no fairness or efficiency costs although there would be a cost to those already benefiting from rents and in the real world potential behavioural changes given incentives to reallocate income offshore.

This note does not analyse when it is and when it is not appropriate to tax returns in excess of the risk free rate of return or tax economic rents. That should be the subject of a separate paper that needs to take into account the practical ability of the tax system to do so and the efficiency and fairness issues that need to be considered.

## Haig Simons Income

The Haig-Simons definition of income is the standard economic definition in public economics. It is defined as the increase in wealth (savings) plus consumer spending over a period of time such as a year.

All gifts, bequests gambling winnings are income under this definition because they increase wealth or are spent on consumption. Some countries do tax such gains (USA in general) but many do not even under capital gains tax rules (Australia). If these items are taxed as income the question arises as to whether the party providing the gift or bequest or that suffers gambling losses should get a deduction for this loss in wealth. Prima facie there is a loss in wealth and so under Haig-Simons a deduction for that. However, the issue comes down to whether gifting, bequeathing or losing money on gambling is taken as being consumption. There is no obvious right answer but as far as I am aware no country gives a general deduction. It is noted that under GST in effect the consumption arising is taken to be the amount of gambling losses (this is what GST is charged on). Many people would be likely to find this reasoning lacking in intuitive sense.

Under a Haig-Simons income tax interest is always deductible. That is because it is an outgoing (reduction in wealth) but not directly consumption (although it can bring forward consumption). The income tax does not allow a deduction for interest on homes or consumer durables but in theory only because it does not tax the imputed rental income of such durables. If we did tax imputed rental income we should, at least in theory, allow deductions for interest on home mortgages. In theory (in this note taken as being applying a Haig-Simons concept of income) we should allow deductions for straight consumer lending (the overseas holiday) but we do not. Theory is not followed in all cases.

Obviously loans are not income since the increased wealth or spending is matched by an offsetting liability.

In a theoretically pure Haig-Simons income tax all numbers are calculated on a full accrual basis. This requires annual valuation of all individual assets and liabilities.

A theoretically pure Haig-Simons income tax also fully integrates the tax of an individual and all entities. For companies if shares were valued at market rates and all consumption was also taxed, there would be no need for a separate company tax. All corporate income would be taxed at the shareholder level. Alternatively, we could fully integrate the tax position of an entity and its owners so that all entity income is attributed to owners. Practical issues arise with uncertain, contingent or variable interests. For example the income of trusts should be allocated to beneficiaries but for discretionary trusts this is never certain and it is common for a trust deed to have a person with power to appoint further beneficiaries.

For owner occupied homes, Haig-Simons income includes imputed rental income. This is the rent (consumption) that a person would have to pay if instead of owning the home they rented it. This is a measure of consumption in terms of accommodation and since Haig-Simons income includes all consumption it should be included in such income. This also applies to consumer durables a person owns – fridges, cars etc. Most economists consider this makes sense but it is unlikely that many non-economists do.

As previously noted, interest on loans to buy these items plus repair and maintenance costs and depreciation should be deductible as reductions in wealth. In practice we deny such deductions. The policy rationale for doing so is that this claws back to some extent the lack of tax on imputed income.

In addition to imputed rental income other forms of imputed income should be included in a Haig-Simons measure of income on the basis of the same rationale. This includes imputed income from, say, mowing my own lawns, looking after the children etc. There is international pressure to bring into national income statistics currently unmeasured income such as home building and family care. This is understandable and has considerable public support. There would probably not be the same support for taxing such income.

## Other Economic and Accounting Concepts of Income

While the Haig-Simons definition of income seems to be the most widely cited, at least in modern public economics, other economic concepts of income also exist.

One of these considers income to be returns on factors of production. This seemed to be the focus of classical economics – Adam Smith, Ricardo through to Marx. The main difference is that windfalls, gifts and bequests, not being returns to factors of production, are not income.

Income can also be economically measured as a person's utility or welfare. This seems theoretically appealing but is not practical for tax purposes given that different people receive different utility (or even disutility) from the same income or wealth. Taxing based on the measurement of individual utility seems very problematic.

There is also the concept of fixed versus circulating capital. Fixed capital is the capital permanently required by the income generating firm (the tree). Circulating capital is capital that is used and produced by the income generating firm (the fruit). This concept of income was widely adopted in equity law to distinguish between the life interests and remainder interests. It is still referred to by Courts in tax cases and was a basis for traditional accounting measurement of income. Accounting has moved away from this towards a more Haig Simons approach. In many ways accounting has moved beyond that. For example, it takes provisions for costs of committed restructuring such as redundancy payments as current deductions along with increases in future lease commitments.

## Issues with Measuring Income under These Concepts

There are a number of issues with measuring income in addition to the differences in how income is measured under the different above concepts.

There is an issue whether income should be measured in nominal (dollars of the day) terms or in real terms (indexed for inflation). Indexation under a Haig-Simons income tax should be based on a broad measure of inflation (such as Consumer Price Index although this is one of such measures). Specific asset price movements are not relevant otherwise by definition there would no asset price gains. Under indexation only the real interest rate is taxable however equally only the real interest rate is deductible. In general economists prefer indexed income as a pure measure of income on the basis that by change in wealth it is meant change in the ability to consume in the future. However, as with most countries, New Zealand income tax measures income on a nominal basis.

Issues arise also with what currency or unit income should be measured in. This is usually (as in New Zealand) the sovereign currency of the country levying the tax. However, for some taxpayers (such as non-residents) a foreign currency would be seen by them as a truer measure of their income. When converting into New Zealand dollars, there is an issue as to what exchange rate to use. This can be the spot cross rate, a forward rate or a rate reflecting purchasing power parity.

The above comments focus on income in terms of financial capital income. Labour income (except imputed income) is assumed to be measured as wages or salary received. In theory it should also be measured on an accrual basis so that annual leave and sick leave should be accrued on the same rationale as such expenses are normally accrued in the accounts of the employer. In pure theory, under a Haig-Simons income tax, income should also include changes in human capital. This is the change in the present value of future labour income derived from earning marketable skills over one’s life. Presumably this results in large incomes over the years of greatest skill development (late adolescence and early adulthood) the time when measured income is often the lowest. Offsetting this, costs of developing skills would be deductible and as one ages a deduction would arise from depreciation of human capital. As a result those from the mid-50s on are likely in theory to have large depreciation deductions – the time when measured income is usually highest.

No one sensible would propose taxing changes in human capital but the pure theoretical positon highlights a number of points:

- No one sensible proposes taxing economic income on a very pure basis just to maintain theoretical purity.

- There would be a considerable change to the inter-generational burden of tax if a very purist approach were adopted. Not taxing human capital results in the current tax burden being shifted from the young to the elderly (the opposite to what is often thought to be the case).
- Not taxing human capital in effect subsidises education and skill acquisition. That is because even though educational costs are not deductible, the human capital created from the acquisition of skills is not taxed. One presumes the monetary benefits of education outweigh the costs although it is necessary to recognise the social benefits that education provides. Another way at looking at this is that the student is not taxed on the opportunity costs of wages forgone while studying. We do not follow any theory to its ultimate (most would regard as absurd) conclusion that we should tax wages form income forgone from choosing leisure over work. It is stressed that normal economic analysis does not treat people as a machine that should be incentivised to work the maximum. The objective of economics is to promote welfare which is not the maximisation of the production of goods and services.

The above have considered income measurement seen in different contexts – real versus nominal. There are other areas where one's view of income can differ according to context.

One is the unit used to measure income. The income tax measures individual incomes. However, in many contexts household (or even a wider unit such as whanau or iwi) may be more relevant. That is especially the case when considering fairness of income distribution. The income tax may measure the income of a young adult living in a wealthy family as being low whereas that person's access to consumption may be very high. Thus Statistics usually refer to household incomes and equalised household incomes (which adjusts for the expected differences in living costs of households with different formations). Social welfare and social tax policies (such as family tax credits) also adopt households as a measuring unit. Of course what is a household can be a fluid and even controversial issue. The expectation as to who shares income and with who tends to be culturally specific.

A second different context in which income is measured is time period. The income tax uses annual income measurement. This dates back to agrarian society when the four seasons needed to be taken into account in measuring wellbeing. That is still true for many firms and businesses (retailing and other seasonal businesses as well as agrarian income). It is not especially relevant for a large and growing section of the population whose incomes are not dependent on an annual cycle. In different contexts different measurement periods can be justified. GST can be measured two-monthly or 6 monthly.

In many cases annual income paints a false picture. For the person unexpectedly unemployed half way through a year with a family to support and little savings or realisable assets, the relevant income is what the household has to live off for the remainder of the year. What was earned in the first half of the year may have little relevance. The tax income measurement tends to ignore this issue but it is critical in income as measured for benefits. A student earning low income now may be classified as low income earning but his/her future earnings may be high and they may have high human capital growth. Conversely a person may earn their lifetime income over a short span of time. There are (admittedly few) cases where a person earns almost all their lifetime income in one

year (for example recipients of compensation claims). In that year they may be measured as high income earners but their lifetime income is low.

Measuring income over a lifetime deals with such problems but is not practical for tax that has to fund the government's ongoing expenditure requirements. However, this illustrates an important point – the relationship between income tax and a tax only on consumption (such as GST). If one views bequests as consumption (all income is in any case ultimately spent or consumed by someone) then consumption or spending is the same thing as income. There is then no such thing as capital income.

As previously put by officials to TWG, income is capital income plus labour income. Viewed from the perspective of income earned, deposited in a bank, and then withdrawn and spent, income tax taxes on a TTE basis. The present value equivalent of this discounted (normally assume to be at the government's borrowing rate) is ETT. The first (or last) T is labour. The middle T is capital. Officials have previously provided a paper showing arithmetically how TTE is equivalent to ETT under certain assumptions.

A consumption tax is EET or TEE. GST, a consumption tax, is generally EET (for housing TEE).

The difference is no middle T in GST or a consumption tax. In other words there is no tax on capital income under GST. GST is just a tax on labour income. An income tax taxes labour and capital income. Put another way – Haig Simons income is consumption plus increase in wealth. If we measure income on a lifetime basis assuming all income is spent, then over a lifetime there is no increase in wealth, just consumption.

If we have a pure ETT income tax measured on an annual basis and everything is eventually spent on consumption, then taxing capital income matter is a matter of timing. It taxes the capacity to spend as it accrues and then again when it is spent. This results in double taxation of consumption. A tax penalty on deferring consumption or in other words a tax penalty on savings. The capacity to spend is measured somewhat arbitrarily on an annual basis. Double tax on consumption results from accruing capacity to spend on less than a lifetime basis.

There is no unambiguous theoretical answer to the question of whether it is fairer or more economically efficient to tax capital income as well as labour income. This seems to depend on one's perspective and the trade-offs involved. There is a view, widely accepted in the first half of the twentieth century that capital income (unearned income as it was called) should be taxed more heavily than labour (earned income). The view seems to be attributed to the fact that capital income is generated from wealth and requires no leisure/work trade off. The person earning capital income can lounge around whereas a person earning labour income may have the same level of income but has no leisure time. Clearly not taxing capital income and increasing tax on labour income benefits most those with most wealth – that is those with most capital income. Whatever one's view, this issue should at least be borne in mind when considering tax policy issues and issues regarding inequality.

## Other Concepts of Income

The above can be viewed as a rather narrowly focused concept of income. There is a trend, at least with respect to national accounting, to attempt broader measures. This takes into account the wider social as opposed to private welfare impacts. For example, income may be generated by exploiting the environment. This may produce private income but wider social costs in terms of it adverse impact on natural and social capital. The traditional tax approach is to try to measure the income of a taxable unit (the individual or household). This by definition does not take into account the wider unit – society as a whole and the interests of future generations. Pigouvian taxes try to adjust for this by attributing the costs of externalities to the generator of those externalities.

There is no necessary consistency between what the average person views as income and the above largely economic concepts. Whereas economics considers income in terms of spending and accrued capacity to spend currently or at a future date, it seems that the average person views income more in terms of the actual capacity to spend now – more like discretionary income – what I have available to spend on myself or household now. The average person is likely to accept that discretionary income he/she decides to save, say in a bank or even KiwiSaver scheme, instead of spend is still income. They could have spent it. However, I argue they do not in general see increase in wealth that is not available to spend as income no matter what economists may say.

For example, I put forward the proposition that if locked in KiwiSaver funds were not taxed at the fund level but instead individuals were personally required to pay tax on fund income attributable to them, there would be public outrage. This seems to be why non-business income is taxed on a cash not accrual basis. It accords with public sentiment. Public sentiment seems at least in part to be conditioned by what is familiar. Switzerland taxes the imputed rental income on owner occupied homes but this does not seem to be controversial.

There are many examples of this. Take the example of a person living in their own home in Auckland. They are enjoying the benefits of home ownership. House prices double. In economic terms this is income but they still receive exactly the same home ownership benefits. This is not seen as income. The explanation that they could sell their Auckland house and live in Dipton and realise some of the gain as income is not likely to persuade them otherwise.

The same is the case with a person living off an annuity bringing in a fixed income stream for life. Interest rates fall and the value of the annuity rises. This is economic income but from the persons point of view nothing has changed. They continue to get the same income stream and they fail to see why they should pay tax because interest rates internationally have fallen because of an increase in the rate of savings in China.

This view of income is not limited to non-business taxpayers. An owner of an SME will usually see income also as discretionary income – what is available to spend, not necessarily what is required to be reinvested. A plumbing firm needs to use half its income to buy a new van for the business. The plumber is taxed on full profits so that the van must be purchased from post-tax income. In many (most?) cases the plumber considers that his/her tax rate is now 66% not 33%.

The FDR tax on foreign shares was, when introduced, very controversial for these sorts of reasons. This taxes a deemed 5% return on the value of foreign shares even if the shares were not sold and provided no dividend. In my view this was able to be enacted because of the argument that listed

shares are substitutable. If a person did not like being taxed at 5% on a non-dividend paying share they could buy one paying a 5% dividend and examples were provided where they could in fact do so. It could be demonstrated that an investment portfolio could relatively easily be figured so that cash dividends were sufficient to cover tax on FDR income.

The above has direct application with respect to the design of any extension of the taxation of gains from capital. An accrual capital gains tax is the economically pure response to the extent that it is accepted that such gains should be taxed. It is conceded that such a tax is not viable. Usually this is on practical grounds regarding the difficulty of valuing assets annually. An even more compelling argument for not taxing on an accrual basis may be that this is not in accord with the intuitive concept of income held by most people.

## The Welfare Concept of Income

When determining income targeted benefits, the welfare system tends to use discretionary income (household, cash, measurement periods of less than a year etc.) but this is uncomfortably balanced by a concern to target benefits to those in need so added to this are a range of other means of support.

For benefits income testing involves:

- the assessment of income over the six months previous to when a person applies for a main benefit, and
- ongoing monitoring of income received in addition to a main benefit.

The assessment period for the income test is:

- annual for Domestic Purposes Benefits, Widow's Benefits, Invalid's Benefits, Transitional Retirement Benefits, and income-tested New Zealand Superannuation or Veteran's Pensions (these persons may, however, elect a weekly income assessment)
- weekly for all other main benefits (unemployment-related benefits, sickness-related benefits, Emergency Benefits), and for all supplementary benefits.

Income is defined in section 3 of the Social Security Act 1964 as any money received (before income tax) that is not a one-off capital payment. It includes wages, salary, commission and Parental Leave payments, and the value of any interest (before income tax) acquired that is not a one-off capital payment. Whether or not money received is taxed is irrelevant to identifying it as income.

Income can also refer to a value in money's worth rather than money itself. For example, where another person is meeting expenses such as rent for the beneficiary, this can be considered as income. The value of free board or free rent is also considered as income. In addition gifts and loans from relatives have been considered to be income.

Beneficiaries are required to declare other income received while they are in receipt of a main benefit. Receipt of other income over a certain level (generally $80 per week before tax) leads to abatement of the main benefit received. Supplementary benefits may be abated due to receipt of other income even when the level of income received is too low to affect the beneficiary’s main benefit.

Other income includes:

- wages or salary
- accident compensation
- farm or business income (including drawings that are in fact a loan not income)
- self-employment
- interest from savings or investments
- dividends from shares
- income from rents
- redundancy or termination type payments
- Child Support
- maintenance payments
- boarders
- Student Allowance, scholarship or Student Loan living cost payments
- any other income, for example family trusts, overseas payments.

Working for Family Tax Credits (family tax credit, in-work tax credit, parental tax credit) are provided through the tax system and thus tend to income test using income tax concepts (annual measurement and general tax measurement rules). However, household income is used (not individual) and various adjustments are made to taxable income again it seems in an effort to target more closely to those in need. Examples are the inclusion in income of maintenance/child support payments, the income of a trust of which the person is a settlor, certain fringe benefits subject to fringe benefits tax, certain PIE and superannuation income, regular gifts. Business and investment losses are ignored. There has been a trend to attributing more income to FTC recipients over time for the purposes of FTC targeting.

Given that people often see Family Tax Credits as just part of income tax (they receive a net of tax number to meet household expenditure requirements) the different income measurement approaches can cause confusion.

Confusion seems greatest with the accommodation supplement. The accommodation supplement is another benefit that people often see as simply part of the income they have to live on post-tax. This is a weekly payment that helps people with their rent, board or the cost of owning a home (e.g. mortgage repayments, house repairs). You don't have to be on a benefit to qualify for the accommodation supplement. A person may be eligible for an accommodation supplement if they :

- have accommodation costs
- are over 16
- are a New Zealand citizen or permanent resident
- normally live in New Zealand
- are not paying rent for a social housing property (e.g. a state house)

Whether a person qualifies for an accommodation supplement depends on

- how much they pay for accommodation (whether it is rent, board or mortgage payments)

- how much they have in income
- how much assets they have.  This excludes a home and car and thus mainly includes financial assets.  I understand the maximum is $20,000 so that a person can own a house and get the supplement to pay a mortgage but cannot be saving for a house deposit and get the supplement
- where they live
- how many dependent children live with them?

Since this is administered by social welfare the income test is that used by the welfare system.  For those not on benefit who see this as part of their net tax income, this is likely to be a total mystery.

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