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What is happening to tax policy in New Zealand and is it sensible?

Norman Gemmell[§]

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Abstract

This paper reviews two recent changes to tax policy settings in New Zealand: an increase in the top income tax rate and a 'housing package'. It argues that both represent *ad hoc* responses without a coherent strategy. Further, government officials' policy assessments confirm these were progressed unduly rapidly, based on limited analysis, and against official advice on the most suitable option to deliver on the government's own objectives. This is likely to result in policy outcomes falling well short of objectives, and potentially serious unintended consequences. Coherence of the tax system in particular is at risk.

Keywords: housing package, tax policy, top tax rate, policy space

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1. Introduction

In debates about economic policy, economists often talk about 'optimal policy instruments'. This is usually characterised as a policy (the 'instrument') which: (i) achieves its objective or target; (ii) does so in a way that is more effective or efficient than the alternatives; and (iii) has minimal unintended consequences. In New Zealand (NZ) the new Labour government, elected in September 2020, has introduced a number of substantive changes to the country's tax regime. These include two largely separate sets of tax changes. First, implementing their election manifesto, a top personal income tax rate of 39 per cent was introduced from 1st April 2021 – but at a much higher annual income threshold, of $180,000, than when this rate last applied in 2009. Second, in March 2021 the government announced its intention to introduce a package of policy measures aimed at dealing with a number of contemporary housing problems. Most of those measures relate to the ways in which housing is taxed.

Worryingly, evidence from official 'regulatory impact assessments' (RIAs) suggest that in both these cases the government's policy choices deviated significantly from those recommended by officials.[1] This raises the obvious question: is the government undertaking distinctly sub-optimal policy reforms? Or, are officials perhaps simply displaying either a different set of preferences or undue commitment to the *status quo*?

This paper examines these two new tax policies in turn. It suggests that, at a minimum, both tax policies appear to have been implemented prematurely, with little suitable official advice. In some cases, officials clearly feel that the government's policy choices could seriously undermine the coherence and integrity of the current NZ tax system. Their concerns would appear to be supported by evidence, where available, and otherwise by 'in principle' reasoning.

2. The New Top Tax Rate

In November 2020, Inland Revenue conducted an RIA into the government's proposed new top personal income tax rate of 39% on incomes above $180,000 (IR, 2020). This clarifies that the objectives of the policy were to, (a) raise more revenue to fund the government's intended future spending; and (b) do so in a way that improves equity. Evaluation of the policy *ex ante* can therefore be decomposed into four important aspects:

(1) How much equity improvement will be achieved?
(2) How much extra revenue will be raised?
(3) What sacrifice in efficiency will be made in pursuing these objectives?
(4) Could the objectives be achieved at a lower efficiency sacrifice?

On (1), empirical analysis from IR (2020) shows that the effect of the top tax rate increase on the Gini coefficient – the most commonly quoted inequality index – is likely to be very small. It is forecast to fall by 0.2%, from 0.493 to 0.491. In fact, despite 'raise the top marginal income tax rate' being a popular mantra of the political left, changes to income tax rates at the top of the income distribution typically have little distributional impact. This is partly because the Gini coefficient weights each individual by the inverse of their rank in the income distribution.

For example, with a population of ten people the richest person receives a weight of 1/10th while the lowest income person receives a weight of 1. Those earning over $180,000 are less than 2% of NZ income taxpayers, so we could characterise the distribution as composed of 50 groups each of 2%,

[1] A RIA is a document that government agencies are required to produce that summarises an agency's best advice to its Minister and Cabinet on all new policy decisions. For more details see, for example, https://www.mpi.govt.nz/legal/regulatory-impact-statements/.

such that those with incomes exceeding $180,000 are given a Gini weight of 1/50th compared to a weight of 1 for the lowest 2%.[2] Unsurprisingly, the Gini inequality measure is, therefore, not very sensitive to changes in top incomes. Gini indices are affected much more by how incomes of the lowest groups are treated. Of course, it may be objected that the equity effects of a tax increase should be assessed jointly with the use of the tax revenues raised. That is indeed a more sensible way to evaluate the policy, considered further below.

On (2) – how much extra revenue is raised? – IR (2020) estimate that, averaged over the first three full years of its operation, the new tax policy will raise, on average, $510 million per year, 2021/22 to 2023/24.[3] This represents just under (over) 0.4% of total Crown expenses (revenue) in 2020; see Treasury (2020). It is clear therefore that the new tax policy has a very limited capacity to increase Crown spending, or increase equality via the targeting of that spending at lower income groups.

On (3) – what sacrifice in tax efficiency can be expected – IR (2020) does not report this. However, economists normally measure it by the deadweight loss (DWL) associated with a tax increase – the extent to which taxpayers' 'utility', or sense of wellbeing, is harmed, per dollar of extra revenue raised. Of course, all tax levels are associated with some utility loss, compared to a no-tax situation. The issue here is how far the increase in tax rates further reduces utility. A familiar approximation for that additional utility loss is that it increases with the square of the tax rate. Mathematically it can be approximated (see Creedy, 2004), as a ratio of after-tax income, by:

$$D/Y \approx \alpha\{t/(1-t)\}^2 \qquad (1)$$

where D is the deadweight loss from the tax increase, Y is the value of taxable income, α is a measure of the responsiveness of taxpayers' incomes to the tax change and t is the tax-inclusive tax rate (the way that tax rates are usually written in income tax legislation).

Thus, the DWL as a ratio of income increases approximately in proportion to the square of the (tax-exclusive) tax rate, $t/(1-t)$. Plugging in values for α, it can be shown that this 18% increase in the top tax rate ((39 – 33)/33) will be associated with a 68% increase in the deadweight loss. This holds irrespective of the value used for α.[4] These are potentially very large losses in wellbeing for those experiencing the tax increase, and hence this 'cost' would have to be given a very low subjective weight by the government if it is to justify the very small effect of the tax increase on equality and extra spending (the 'benefit'). It may be argued that, implicitly, this is the current government's 'revealed preference'.

A more limited estimate of the efficiency losses from tax 'restructuring' and avoidance associated with the new policy can be gleaned from the same data in IR (2020). Table 1 below uses data from Table 3 of the RIA and publicly available IR data on taxpayer numbers and total taxable income, to derive average taxable income in each income band.[5] The right-hand column shows how much additional tax revenue would be raised from the $0.06 increase in the top tax rate if there is no

[2] In fact, IR taxable income data for 2019 show that, excluding taxpayers with zero taxable income, those earning $1 – $10,000 annually comprise over 16% of taxpayers; see https://www.ird.govt.nz/about-us/tax-statistics/revenue-refunds/income-distribution.

[3] The staggered timing of provisional income tax collection means that these values are quite different across the first three years ($160M, $830M, $540M; M = million); see IR (2020, p.3).

[4] For example, with $\alpha = 0.25$, D/Y = 6.1% when the top rate is 33% but D/Y = 10.2% when the top rate is 39% – a 68% increase in D/Y. These DWL values (6.1% and 10.2%) can seem quite small losses; however, measured as a proportion of the tax revenues raised, then if R/Y ≈ 0.33; D/Y increases from 18% to 31% of revenue when the top tax rate is increased.

[5] The number of taxpayers shown on the IR website (see note 2) is slightly different from those reported in IR (2020), the latter likely an updated version. However, taxpayer numbers are sufficiently similar that estimates of average taxable income by income band should be only slightly affected at most.

behavioural response to the tax change; that is, assuming average taxable incomes reported in each income band in 2020 remained unchanged. This yields a total revenue gain of $695 million. However, as noted above, IR (2020) estimates of actual revenue expected from the tax increase – with an unchanged trust tax rate – is around $510 million; slightly less than the 2020 Labour election manifesto estimate of $550 million.

Table 1 Additional Income Tax Revenue

Income band	Number of people	Ave taxable income ($)	Additional Revenue ($M)
$180,000 - $190,000	10,500	*184,775*	3.01
$190,000 - $200,000	8,600	*194,790*	7.63
$200,000 - $210,000	7,000	*204,799*	10.42
$210,000 - $220,000	7,000	*214,972*	14.69
$220,000 - $230,000	5,700	*224,789*	15.32
$230,000 - $240,000	4,800	*234,938*	15.82
$240,000 - $250,000	4,200	*245,450*	16.49
$250,000 +	38,900	*442,242*	612.07
Total	**86,700**		**695.45**
IR (2020) estimate:			**510.00**
IR (2020) estimate (trust rate = 39%):			**878.33**

Source: IR (2020) and author's calculations using data from www.ird.govt.nz/about-us/tax-statistics/revenue-refunds/income-distribution

This suggests a roughly 36% loss of income tax revenue ((695 – 510)/510) due to behaviour changes such as tax planning and avoidance, assuming all 'missing tax' at the 39% rate is taxed instead at 33%. This number could rise substantially if the avoided income tax is either taxed at the corporate income tax rate of 28% or avoids tax altogether. Had the government adopted the IR (2020) recommendation to also raise the trust tax rate to 39% (*if* the top personal rate was similarly increased), IR estimate a revenue gain of $878 million. In other words, a revenue gain of around 72%of the actual amount forecast ((878 – 510)/510) is expected, split roughly equally between revenue effects from personal income tax and trust tax changes.[6] This is a very substantial forecast revenue loss from the government's chosen top tax rate option, largely due to undermining the integrity of the personal income and trust tax regimes.

On policy evaluation aspect (4) – could these equity and revenue objectives be achieved at lower efficiency sacrifice? – the answer is almost certainly yes. First, as noted above, IR (2020) argues that, at a minimum, raising the trust tax rate to align with the top personal rate would substantially improve the integrity of the system, raise more revenue and reduce the restructuring that will result when the top personal rate only is increased.[7]

Second, examining a range of detailed alternative policies is beyond the scope of this paper. However, as argued above, since the Gini inequality index is much more sensitive to incomes at the bottom of the distribution, reducing income tax payments for those taxpayers is likely to be much more effective. If tax revenues have to be maintained, it would be better – in terms of equality improvements delivered at lower efficiency losses – to raise GST rates (for all) and lower income tax

[6] It might reasonably be assumed that the IR (2020) estimate, when both tax rates are increased, includes some behavioural change such as switches to the corporate tax regime.

[7] IR (2020), however, do not estimate the increased DWL that will likely arise from the higher trust tax rate which will tend to counteract the reduced DWL from improved integrity. In addition, some integrity dimensions will worsen due to the larger (11, previously 5, percentage points) gap between the top personal rate and the corporate tax rate.

rates only at the bottom of the income distribution. Alternatively, income transfers to lower earners (such as via family tax credits) could be paid out of higher GST revenues and almost certainly reduce inequality indices. Similar scenarios have been examined rigorously by Thomas (2015, 2020) and shown to be more effective for redistribution across many OECD countries including NZ.

The discussion above certainly does not qualify as careful 'analysis' of the top tax rate policy. However, there would seem to be a *prime face* case that, in addition to giving tax officials insufficient time to conduct suitably careful analysis (about which the RIAs suggest they feel strongly), the tax increase option pursued by the government is a long way from an optimal choice. This is all the more surprising when it is recalled that former Labour Finance Minister, Michael Cullen, also failed to raise the trust tax rate with the top personal rate in 2001. Subsequently, this was widely recognised as a mistake, with clear evidence that it led to substantial tax sheltering of personal incomes, undermining the government's own objectives; see Gemmell (2020).

It is hard to avoid the conclusion that the new higher top tax rate is a policy designed to deliver the *appearance* of redistribution by focusing attention and revenue-raising on top earners. However, especially given the way the new policy has been structured, the actual effects are likely to be minimal on equality and small on revenue, but will impose significant costs in terms of the efficiency and integrity of tax revenue-raising in NZ.

3. The Housing Tax Package

The second major tax policy introduced by the new government – but which was not foreshadowed in the election manifesto – is a package of reforms to the taxation of housing. This is combined with a number of other legislative changes related to housing, though the tax component is clearly the major reform.[8]

The main elements of the package are these:

- Phasing in the removal of the tax deductibility of interest on loans for residential investment properties.
- Extending the bright-line test – the end date of the period during which the property sale attracts a capital gains tax (CGT) liability – from 5 to 10 years.
- 'New builds' to be favoured in the above tax treatments, for example retaining the 5-year bright-line threshold for new properties.
- A new 'changes of use' rule that effectively means a main family home will be liable to CGT if it is sold within 10 years of purchase and has been rented out for a 1 year or more during that period (levied *pro-rata* on the fraction of time rented).[9]
- A new $3.8 billion 'Housing Acceleration Fund' to encourage housing development by 'funding the necessary services, like roads and pipes to homes' (Housing Minister, Megan Woods).

We can evaluate this policy using the same three characteristics of optimal policy noted in section 1.

Achieving the policy's objective

Economists have a policy 'rule' (derived rigorously in the 1950s by the Dutch Nobel-winning economist, Jan Tinbergen) that to achieve a given number of independent policy objectives, you need

[8] For example, the income caps for new buyers accessing the government's First Home Grants scheme have been increased marginally.

[9] This is despite Finance Minister, Grant Robertson, saying in a government press release that 'I want to stress that the bright-line test does not and will not apply to the family home' (https://www.beehive.govt.nz/release/govt-housing-package-backs-first-home-buyers). Yet, clearly, it does apply to anyone with a single home who rents it briefly. It is unclear whether this also applies to a 'live in' tenant in a family home.

at least as many independent policy instruments. It is debatable how many independent policy 'instruments' the new housing package represents, since it contains several inter-related, as well as separate, measures. However, it has several explicit objectives including stabilising house prices; facilitating home ownership; discouraging 'speculative' (definition elusive) housing investment; increasing the housing stock, especially of 'affordable homes' (definition elusive); and closing what Ministers describe as a housing 'tax loophole'. Add to that an implicit objective of tackling perceived inequalities in income and wealth between tenants, landlords and home owners. That is quite a task for any set of policy instruments to achieve! Indeed, with such wide-ranging objectives it would be remarkable if any set of housing policies could reach them with much success.

Arguably the primary objective of this housing package is stopping the rapid increase of house prices, especially high in Auckland in recent years.[10] Failing to achieve this would simply put it among a long line of policy attempts by previous NZ governments (National and Labour) that have been tried over the last 20 years at least. In all cases the biggest problem has been insufficient attention to boosting housing supply. Of the current policy, the Ministers' press release claims that the policy 'will help green light tens of thousands of house builds in the short to medium term'. This time horizon may describe the setting of a 'green light', but it almost certainly will not deliver a substantive short-to-medium increase in the housing stock. Anyone doubting that statement need only consider the response to the KiwiBuild policy during the last government, and the existing (and expected future) constraints faced by the construction sector.

Unintended consequences

All taxes cause 'distortions', most of them unintended, which need to be mitigated. Additionally, policies which have conflicting objectives are 'incoherent' and typically among the most distorting.[11] Such incoherence would seem to apply to the denial of interest deductibility by the housing package. Previously in NZ and in almost every other country, interest on commercial loans is treated as a legitimate business expense and hence tax deductible, regardless of the nature of that business. In NZ in particular, they are part of a coherent corporate tax regime that treats interest payments on investment funded by borrowing, but not when funded by new equity (share issue), as tax deductible.

Now in NZ that coherent principle has been put aside. If tax deductions on housing investment loans are to be denied, what about other types of business loans which future governments think should be favoured or disfavoured? Should so-called 'ethical' investments be tax favoured with preferential interest deductibility? Or what about investments in environmental mitigation? No doubt argument can and will be made for each of those, but such policies would result in an increasingly *ad hoc* tax system generating multiple undesirable distortions, and tax lobby groups with perverse incentives. This is not 'closing a tax loophole' but introducing a major tax distortion to a previously coherent regime.

If there is a coherent argument in favour of the interest deductibility denial, it would run as follows. Economists often distinguish between goods used for consumption today and those that represent investment for tomorrow. In practice, there is more of a continuum, with perishable food providing an example of a 'pure' consumption good, and an interest-bearing government bond a 'pure' investment good. Residential housing sits somewhere in the middle since it is both a source of housing

[10] For example, in 2017, Kendall (2016) estimated that, over the previous three years, Auckland house prices had risen by 52%, while they increased by only 11% on average over the rest of the country.

[11] Examples of conflicting objectives in NZ tax policy include seeking to tax all income at a uniform rate across a broad base for fairness or efficiency reasons, while at the same time offering lower tax rates on some types of income (such as portfolio investment income or retirement savings) to encourage such activities.

consumption (whether as tenant or homeowner) and a housing investment for landlords – bringing a return in the form of rent and potential capital gain.

It would also be coherent to argue that, for goods that are close substitutes, tax rates should be as close as possible. This aims to avoid buyers choosing between different goods delivering the same utility, based purely on their tax treatment. In the housing context that could lead to taxing similar investments in different industries and assets, including housing, identically – as the current rules do. However, it could alternatively lead to taxing housing used for consumption identically to housing used as an investment. This could be achieved by taxing home-owners imputed rent and making all investment loans tax deductible. For various reasons, this latter approach does not happen and would be difficult to introduce.

The new policy of denying interest deductibility for rental housing loans makes the choice between different motives for housing spending (consumption versus investment) more equal but at the expense of introducing a major incoherence to the taxation of investment financing. Further, even with this new housing package, the new tax system – with no tax on home owners' imputed rent, but (even higher) tax on landlords' rental income – penalises some housing spending but not others. If there is a tax loophole here, it is the longstanding policy that treats home-owners' imputed rent as non-taxable.

With an objective of increasing housing supply, it could be argued that the 'new build' aspect of the housing package (a genuine new-created 'loophole') has got some tax incentives right – to maintain landlords' relative returns from rental housing investment only if that involves adding to the housing stock. However, it must be doubtful whether this will generate a net improvement in the housing 'problem' as perceived by the government. If the binding constraints on building new houses lie elsewhere – such as planning regulations, release of suitable land and construction labour shortages – the 'new build' policy is likely to have little impact on new housing stock.

If it does not significantly increase supply, it will simply shift some housing investors from competing with first-time buyers over existing properties to competing with them over new properties, with consequent price effects. To this will be added the unintended consequence of an incoherent housing tax policy in which over time, the rental housing stock becomes a patchwork of properties where some do, and some do not, qualify for 'new build' tax exemptions. At present the government is still consulting on how to resolve this conundrum. Exploiting the inevitable resulting tax loopholes and assorted distortions to the prices of different properties, will likely provide plenty billing hours for tax accountants!

The bright-line test is another policy dimension that lacks coherence, in part because it is rarely the case that a tax policy whose liability is based on *transactions* and/or *timing* is good tax policy design. The bright-line test – of whatever length – does both. It incentivises delaying property sales to avoid the tax even when this conflicts with the best commercial or personal interest of the taxpayer. As originally introduced as a 2-year test by the Key government in 2010, it was hard to justify as a coherent strategy, not least because it was not based on any evidence on the timing of property sales by investors, and with no problem definition regarding what constituted 'property speculation'.[12]

[12] Pejorative references by politicians to 'property speculators' are often used interchangeably with those who are 'flipping properties' – where investors are alleged to buy property merely to hold them for later resale at a profit. However, such a definition would capture many legitimate small building firms who buy run-down properties, renovate and then resell at a higher price, perhaps within a year or two. Most such cases seem better described as useful economic activity towards housing improvement than 'speculation'.

Raising this to 5 years by the 2017-20 Coalition government, and now to 10 years, cannot credibly be described as a policy to deter short-term speculation. It is simply a back-door CGT. As with most such back-door policies, this political approach to a CGT is inevitably less transparent and coherent than designing a policy to tackle the problem 'front-on'. A more coherent, as well as politically more transparent, approach would tax capital gains similarly on all assets and regardless of how long they have been held – which sounds very much like something proposed by the 2019-20 Tax Working Group!

Despite Ministers' claims to the contrary, this new CGT will apply to family homes if these have been partially rented out. No data has been made available on what fraction of family home-owners may fall within this category but it could be non-trivial.[13] For example, home-owners in expensive cities such as Auckland, when moving temporarily out of the city (for example due to a short-term job relocation) will typically find it economically disadvantageous to sell that home. The combination of high transactions costs and the likelihood of losing via faster Auckland price rises when trying later to buy back into the same market, means it is generally better to rent temporarily in the new location, funded by renting out the Auckland home. Similar arguments apply to other cities with relatively high house price inflation.

An illustration by the journalist Henry Cooke provides a salient example.[14] Consider a taxpayer earning $80,000 per year who buys a family home for $1 million. After 6 years the house is sold for $1.6 million, having been rented for two of those intervening years while the owner rented elsewhere. Cooke shows that this taxpayer will have a CGT liability of $72,000 under the new tax regime – nearly a whole year's salary – simply to move to an equivalent priced home.[15]

Alternative policy instruments

If the current housing package seems worryingly incoherent, are there more coherent alternatives? There isn't space here to delve into this in detail. But, it is unequivocally the case that *ad hoc* tinkering with a coherent tax regime should be avoided as a priority. Instead, strong incentives to encourage, and enable, house building are required. This has applied particularly to Auckland for some time, but may be becoming increasingly relevant in other cities such as Wellington. Current and previous governments (National and Labour) have failed to deal with this, in part by aiming their housing policies nationwide, when the house price inflation problems have been almost exclusively *urban* and, until recently, Auckland.[16]

Without biting the hard political bullet of reforming regulations around the construction sector (e.g. allowing more building 'up' as well as 'out'), and designating more close-to-city land for urban zoning, there seems little prospect of house prices in Auckland and other cities stabilising given current

[13] A problem of lack of analysis and consultation in a short time-frame seems to have characterised this housing package more generally. Treasury (2021, p.2) complained that 'this Regulatory Impact Statement has been produced under extremely tight time constraints without consultation or the benefit of robust data, and accordingly there is a risk that the analysis is incomplete or may miss key interactions'.

[14] See https://www.stuff.co.nz/national/politics/300260832/how-the-government-is-changing-rules-for-renting-out-your-main-home-and-the-brightline-test?rm=a.

[15] There is, of course, an untaxed capital gain of $400,000 (two-thirds of the $600,000 price rise) in this case but since this relates entirely to the period of family home occupancy, it should not be taxed if treated symmetrically with capital gains on other family homes.

[16] The Treasury's (2021), rather timid and partial, suggestion is: 'on balance the Treasury's preferred option is an extension of the bright-line period from 5 years to 20 years with no exemption for new builds'. This Treasury proposal would produce something close to a CGT on rental housing, still based on transactions and timing (with delayed timing effects), but which leaves all other capital gains untaxed. They do not examine other dimensions of the housing package noting, on interest deductibility, that 'given time constraints and lack of analysis, the Treasury does not recommend progressing the interest deductibility proposal without further analysis'.

demographic- and income-driven housing demand trends. Ironically, raising the income cap on the government's home loan scheme, rather than incentivising supply, can be expected to further raise housing demand in the short run.

If housing supply is to be expanded significantly, and quickly, the government needs to look at substantial policy shifts to bring more land into residential use and facilitate new construction on such land. That is likely to mean rezoning some rural land (whether currently farmed or non-farmed) and subsidising investment in public infrastructure associated with these new developments. Such a subsidy could involve compensating local councils for reduced or cancelled 'development contributions', which would encourage new builds by reducing builders costs and/or reduce new house sale prices (where these cost are no longer passed on to buyers).[17] Rezoning of land is often a controversial policy, with voters generally disliking 'urban sprawl' and encroachment on recreational or conservation land. However, the (likely unintended) consequence of refusing to consider such policies is perpetuation of substantial income gains to existing property owners at the expense of non-owners, and older, at the expense of younger, New Zealanders.

4. Tax Policy Conclusions

The incoming National government of Prime Minister John Key in 2008, and PM Jacinda Ardern's new Labour government both inherited huge economic upheavals – the global financial crisis (GFC) and the Covid19 pandemic, respectively. Both called for quick, decisive and coherent action to avoid deepening crises, and both governments have been praised for their nimble, coherent policy responses to these 'shocks', including government tax and spending decisions.

The Key government, however, largely failed to tackle the worsening housing affordability problem that existed in Auckland before the GFC and picked up again soon thereafter. The current government, when it comes to designing longer-term economic policies, such as the recent top income tax rate rise and the housing package, seems to be adopting a series of *ad hoc* responses without a coherent strategy. Further, on both sets of policies, evidence from officials' assessments confirms that these were progressed unduly rapidly, with a lack of suitable analysis, and against official advice on the most suitable option to deliver on the government's own objectives. Not only could this see outcomes falling substantially short of their many objectives, but serious unintended consequences seem likely to follow. Coherence of the tax system in particular, once undermined, can be very hard to re-establish.

5. Assessing Tax Policy Proposals

The foregoing discussion suggests a possible framework for thinking about sensible tax policy design or reform. In particular, a distinction can be drawn between policies that are economically and/or socially desirable (within the constraints of what is feasible and can be supported by evidence) and policies that are politically implementable. In the first instance it is not the role of the tax policy adviser to prejudge what tax settings politicians will, or will not, be willing to pursue. Politicians and ministers can have a variety of both self-interested and socially responsible notions of what they want to achieve with taxation policy. These will often reflect their own value judgements regarding the outcomes of those policies such as who within society gains and loses. However, it is vital that tax analysts offer policy choices that are based on sound economic analysis whilst recognising implementation constraints and are as free as possible from their own value judgements. They should

[17] Local Authority 'development contributions' are levies on new building developments and some building alterations. They aim to contribute to the cost of providing new local amenities, such as roads, water supply, storm/waste water infrastructure, libraries etc.

also seek to make explicit the (often implicit) value judgement that underlie ministers' objectives and policy preferences. This way, they can hope to guide political decision makers towards policies that will achieve their objectives as fully as possible and with fewest undesirable side-effects.

Two political reactions in particular should be recognised. First, when considering possible new taxes or tax reforms, ministers will often (reasonably?) consider whether such action would risk too much 'political capital' in the form of voter backlashes. As a result they may prefer policies that minimise political risks, while economic analysis identifies that such risk-minimising policies are also economically much further away from an optimal policy than an alternative tax policy. Avoiding presenting ministers with the alternative option on the grounds that 'ministers would never adopt it' is not a good reason for treating it as 'not practical'.

Second, politicians on the left and right of the political spectrum can readily express a policy preference based on limited knowledge of the underlying merits and demerits. As discussed earlier, examples on the left include focusing on a highly redistributive tax policy while denying or ignoring efficiency consequences or adopting a politically popular redistributive tool when the same outcome could be achieved more efficiently by an alternative.

An example on the political right includes a, usually false, belief that lowering tax rates will lead to higher revenues (because existing, high tax rates put taxpayers on the 'wrong side' of the Laffer Curve).[18] Both such cases need testing by rigorous analysis and frank advice, to confront ministers with the consequences of their policy choices, even if they decide subsequently to go ahead. In this case, the more rational or closer-to-ideal economic policy may not be politically achievable, but it is vital that it is part of the policy menu presented as implementable in principle and in practice.

The above points can be illustrated by the simple framework in Figure 1. This depicts a two-dimensional 'policy space' to capture policy success according to two characteristics. These are: how close the policy is to an ideal or 'reference' policy structure (explained below) on the *x*-axis, and the policy's 'political acceptability' on the *y*-axis.[19] This policy space captures the notion that key to a policy's success is (i) the ability of the policy to deliver fully on its intended (economic and/or social) objectives; and (ii) the probability that the policy is adopted politically as 'official policy'. The latter is proxied here by how far the political decision-takers perceive that legislating the policy will affect their probability of re-election.[20]

In Figure 1, point F represents the status quo policy stance. This may be less than the politician's ideal on the line CH, such as at G; for example, where a current government inherits a predecessor's policy position. Of course, almost no policy is likely to be perceived as *guaranteeing* re-election (on the line CH). The 'reference policy' – captured by the line EH – is that which is regarded by advisers as best able to deliver on all its stated objectives. It is this which policy advisers should be striving to achieve. It is, of course, inevitable that an ideal or reference policy will be determined in part by value

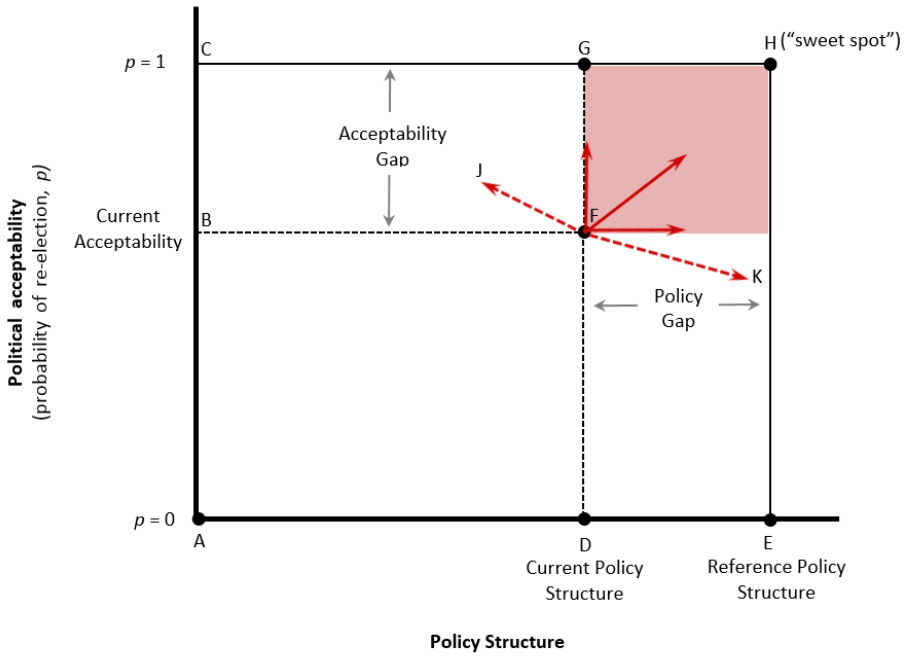
[18] The term refers to an alleged empirical relationship between the marginal tax rate and tax revenue collected, with a hypothesised maximum revenue somewhere between the two extremes of 0% and 100% tax rates, and zero revenue raised at both extremes. How useful the curve is, and where the revenue-maximising rate might be observed, is a matter of some debate in the public finance literature. The curve is associated with the US economist, Arthur Laffer, an advisor to US President Ronald Reagan (and more recently President Donald Trump); see Laffer (2004).

[19] This diagram is adapted from a somewhat similar diagram in the 'tax gap' literature; see Hutton (2017).

[20] Clearly, political motivations are likely to be multifaceted in practice, but re-election (or 'electoral popularity') seems likely to be a prominent element in many cases. It serves as a useful proxy here but is not fundamental to the analysis.

judgements, such as those involving trade-offs between multiple policy objectives. In this case, policy advisers may need to recognise, and present, a number of possible reference policies – perhaps represented diagrammatically by a wider rectangle, rather than a line, of reference policies around EH (not shown in Figure 1).

Figure 1 The Policy Space



Policy advice should seek to move policies adopted from F to a point on EH. The reference policy at H might be regarded as a policy 'sweet spot' since it delivers on all its objectives and is highly likely to be legislated politically. In this sense, proposals that shift policy in a north-east direction are likely to be the most successful. However, in devising a menu of policy options it is important that advisers do not ignore policies that achieve a shift south-east from current policies towards a point such as K in Figure 1. This goes a long way towards achieving the economic/social 'ideal' even if the current government regards it as politically inferior.

Equally importantly, politicians' re-election imperative all too readily creates a temptation to propose policies that move towards J in Figure 1, rather than K. These are policies that undermine, rather than enhance, the economic/social objectives or integrity of current policy and should be resisted by advisers. According to one senior New Zealand public servant: 'our job is not to tell politicians what they want to hear but what they ought to do. If they disagree with us and insist on doing something we think is stupid, our job is to tell them the least stupid way of doing it'![21] In Figure 1 this might be represented as trying to limit a policy movement leftwards from F, especially when such policies aim solely or primarily to improve electoral popularity.

[21] This sentiment, if not the wording, is sometimes attributed Henry Lang, the respected New Zealand public servant, and Treasury Secretary from 1968-77. If so, it may have been at least partly based on Lang's experience of Prime Minister Muldoon's attitudes and policies. According to Holmes (2007, p.44), following a meeting with Muldoon, Lang wrote in his diary: 'his ignorance was exceeded only by his breathtaking arrogance'.

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