



Depreciation and land tax

Assessment of selected Tax Working Group recommendations

Report to Property Council of New Zealand

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Key points

The Property Council of New Zealand (PCNZ) has engaged NZIER to assess the merits of two policy recommendations by the Tax Working Group: removal of depreciation on buildings and introduction of a land tax.

Our analysis¹ shows that these recommendations:

- (i) Are inconsistent with the ‘good tax policy’ criteria set out by the Tax Working Group.
- (ii) May work against over-riding government objectives to become more internationally competitive in order to close the income gap with Australia by 2025.

Removing depreciation on buildings would raise tax expenses for businesses. It would increase the effective marginal corporate tax rate from 30% to 32%. This is clearly against the Tax Working Group’s “critical concern” that “New Zealand relies heavily on taxes most harmful to growth – particularly corporate and personal taxes on capital.”

In addition, depreciation of commercial buildings is common practice in the OECD. Removing depreciation in New Zealand would make us an outlier and reduce our international tax competitiveness. This could hamper already weak foreign direct investment into New Zealand, the health of the local capital market and erode export competitiveness.

This is clearly counter to government policy objectives of making New Zealand a more internationally competitive economy and would place us at a further disadvantage to Australia.

A land tax would be efficient and fair only if broadly and uniformly applied. New Zealand has a long history of land taxes beginning in the late 1800s. Exemptions and reductions have made land taxes politically unsustainable. They were finally repealed in 1990. We see no reason why a land tax in the future should be any more politically sustainable, particularly given the strong views of key stakeholder groups such as farmers, retirees and Iwi.

A land tax would also impact on land prices. This would impact on banks – at least 2/3 of bank lending is to land based and housing segments. This could impact on the cost and availability of capital - and consequently on economic growth – perhaps for a protracted period.

Our initial analysis strongly suggests that far more detailed analysis and rigorous debate is required before these ideas progress further. Otherwise potentially damaging policy decisions could be made.

¹ Our analysis looks at these policy suggestions in isolation and not in the context of potentially offsetting policies.

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1. Introduction

The Property Council of New Zealand (PCNZ) has engaged NZIER to assess the merits of certain policy recommendations by the Tax Working Group (Buckle et al, 2010). We consider the merits of two particular recommendations in this report:

- *“Removing tax depreciation on buildings (or certain category of buildings) if empirical evidence shows that they do not depreciate in value.”*
- *“...introduction of a low-rate land tax as a means of funding other tax rate reductions.”*

2. Removing tax depreciation on commercial buildings

“Removing tax depreciation on buildings (or certain category of buildings) if empirical evidence shows that they do not depreciate in value.”

We assume that tax depreciation is removed from commercial property. Our analysis shows that:

- depreciation of commercial buildings is common practice among OECD countries
- removal of depreciation on commercial buildings would effectively increase the marginal corporate tax rate from 30.0% to 32.1%
- to keep the tax bill for businesses the same, the corporate tax rate would have to be cut from 30.0% to 28.0%.

The removal of commercial property depreciation would:

- raise tax costs, which is clearly against the Tax Working Group’s *“critical concern”* that *“New Zealand relies heavily on taxes most harmful to growth – particularly corporate and personal taxes on capital.”*
- violate some of the key criteria set out by the TWG, in particular economic efficiency and growth by reducing the incentive to invest
- violate one of the key objectives of the Capital Market Development Taskforce (CMD) by effectively raising the cost of capital
- violate the spirit and intent of the CMD and 2025 Taskforces by reducing New Zealand’s international competitiveness, by removing depreciation which is commonly in place in the OECD.

2.1 Depreciation of buildings common in the OECD

A compilation of OECD country tax practices, summarised in Figures 1 and 2, show that New Zealand is similar to the OECD in the treatment of building tax depreciation. The real divergences appear to be in the absence of a capital gains tax, harmonisation of various tax rates and a higher value added tax.

The analysis of OECD countries suggest New Zealand’s current rules on building depreciation are the norm. Removing this depreciation would impose a cost on New Zealand businesses that is not commonly found in the OECD. New Zealand would be less competitive in the global scene, and in particular less attractive relative to our

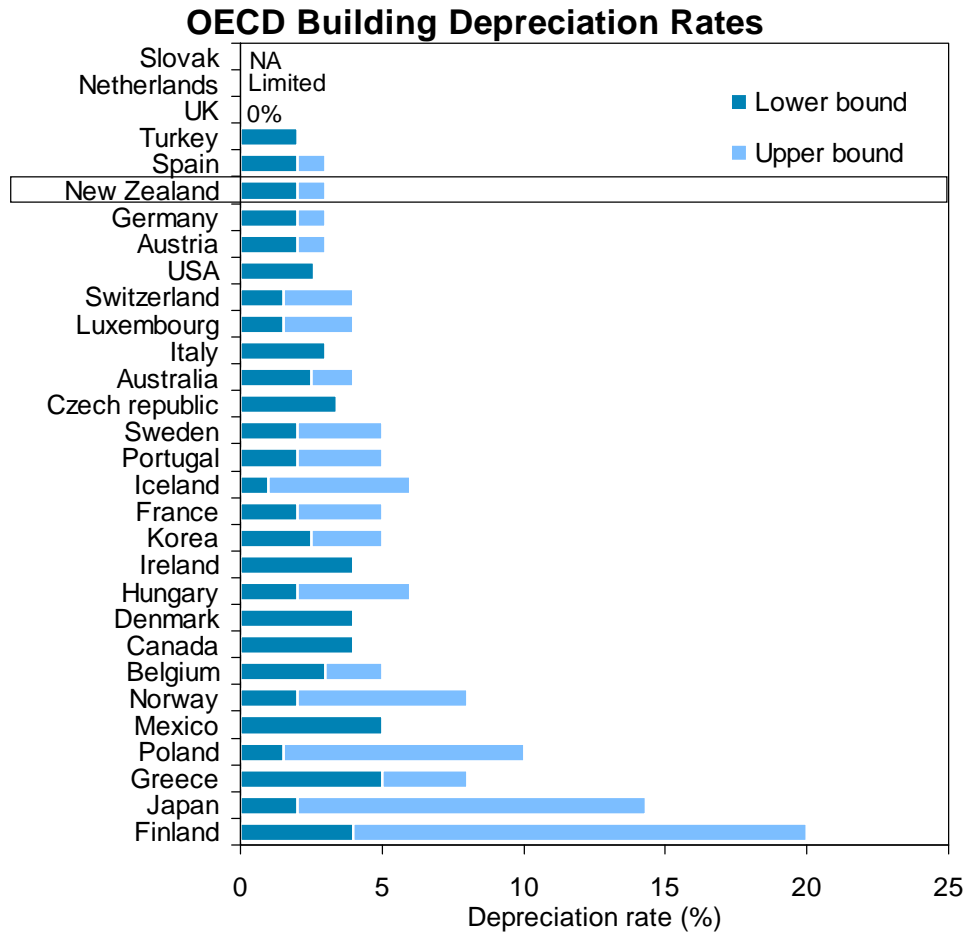
closest competitor Australia. New Zealand already allows less depreciation on buildings (2%) than Australia (2.5%-4.0%). This has the potential to weigh on foreign direct investment into New Zealand (which is already low).

Figure 1: Selected tax information of OECD countries

	Main corporate tax rates			Value added tax		Building depreciation	
	Corporate	Capital gains	Branch	Main	Selected	Straight line	Accelerated
Australia	30	30	30	10	-	2.5-4	-
Austria	25	25	-	20	10	2-3	-
Belgium	33	33	33	21	-	3-5	-
Canada	19	9.5	19	5	13	-	4
Czech republic	20	0/20	20	19	9	3.4	-
Denmark	25	25	25	25	-	4	-
Finland	26	26	26	22	-	-	4-20
France	33.33	0/15/33.33	33.33	19.6	-	2-5	-
Germany	15	14	15	19	7	2-3	-
Greece	25	25	25	19	3-13	5-8	-
Hungary	10/16	10/16	10/16	20	5	2-6	-
Iceland	15	15	15	24.5	7	-	1-6
Ireland	12.5	22	12.5	12.5	0-13.5	4*	-
Italy	27.5	0/27.5	27.5	20	4-10	3	-
Japan	30	30	30	5	-	2-14.3	5-35.7
Korea	25	25	25	10	-	2.5-5	-
Luxembourg	21	21	21	15	3-12	1.5-4	-
Mexico	28	28	28	15	0-10	5	-
Netherlands	25.5	25.5	25.5	19	0-6	Limited	-
New Zealand	30	-	30	12.5	-	2	3
Norway	28	28	28	25	8-14	-	2-8
Poland	19	19	19	22	0-7	1.5-10	-
Portugal	25	25	25	20	4-14	2-5	-
Slovak Republic	19	19	19	19	10	na	na
Spain	30	30	30	16	4-7	2-3	-
Sweden	26.3	26.3	26.3	25	6-12	2-5	-
Switzerland	12.7-25	-	12.7-25	7.6	2.4-3.6	1.5-4	3-8
Turkey	20	20	20	18	1-8	2	-
UK	28	28	28	17.5	0-5	0% from 2011	-
USA	35	35	35	Various	Various	2.6	-

*Source: Ernst & Young (2009) (*Industrial only)*

Figure 2: Building depreciation rates among OECD countries



2.2 Removing depreciation lifts tax costs for business

Depreciation is a non-cash expense for businesses, which spreads capital expense over the life of the investment. The effect of depreciation is to reduce the tax burden (by reducing the taxable income by the depreciation amount) and lift after tax cash income.

Removing depreciation on buildings would lift the effective corporate tax rate from 30% to 32%. Removing all depreciation (not just buildings) would lift the effective corporate tax rate to 42%.

2.2.1 Removing building depreciation lifts effective tax rate to 32%

We estimate the removal of commercial building depreciation would levy large costs on New Zealand business (around \$1 billion in 2008). This equates to effectively increasing the marginal corporate tax rate from 30.0% to 32.1%. Keeping the business tax bill the same would require a corporate tax rate of 28.0%.

Figure 3: Removal of building depreciation scenario

Data in \$b	2008 actual	Without depreciat ion	Change	
			%	\$b
Income	561	561	0%	0
Expenses	513	510	-1%	-3
Building Depreciation	3	0	-100%	-3
Other depreciation	16	16	0%	0
Other expenses	494	494	0%	0
Taxable income	47	51	7%	3
Statutory tax rate	30%	30%	0%	
Cash income pre tax	67	67	0%	0
Tax paid	14	15	7%	1
Cash income	52	51	-2%	-1
Effective marginal tax rate	30.0%	32.1%	+2%pt	0

Source: Statistics NZ, NZIER

The data on depreciation and taxable structures is limited in New Zealand. While due care has been taken, the estimates are illustrative. We estimate the 2008 building depreciation amount by assuming it is 3% of the market value of non-residential buildings (the statutory rate is 4%, but this applies to historical cost, not market value). All data in Figure 3 relate to all businesses in New Zealand as recorded by Statistics New Zealand in the 2008 Annual Enterprise Survey.

2.2.2 Removing all depreciation lifts effective tax rate to 42%

We also analysed a scenario where all depreciation is removed. While this was not a recommendation of the TWG report, it serves to highlight the significant divergences between industries. Capital intense buildings may face marginal tax rates in excess of 50%.

Without any depreciation net cash income by businesses in 2008 would be \$6b (or 11%) lower. This equates to an increase in the marginal tax rate from 30.0% to 42.2%. Supporting tables can be found in Appendix A.

2.3 Assessment against criteria

Removing depreciation on commercial property does not stack up against the criteria and objectives set out by the TWG, Capital Market Development Taskforce and 2025 Taskforce. We consider the policy in isolation and not in the context of potentially offsetting policies.

Figure 4: Stacked against criteria

Group and criteria	Meet?	Comments
Tax working group		
Efficiency and growth	N	Reduce economic efficiency and growth. Depreciation allowance typically promotes investment in capital. New Zealand's low productivity growth and demise in economic leader-boards is in part explained by low capital intensity. Policies that discourage investment can be detrimental to economic growth.
Equity and fairness	N	Puts NZ businesses at a disadvantage in an international context, given depreciation of buildings is generally allowed offshore. Fair within a domestic context as it does not discriminate by property type.
Revenue integrity	Y	Removal of depreciation allowance on property would reduce a bias in investment in residential property.
Fiscal cost	Y	Raise revenue by around \$1.3b (about \$1b from commercial property).
Compliance and administration cost	Y	Would likely reduce compliance and administration.
Coherence	N	Removal of depreciation on commercial property would move NZ away from the 'norm' in the OECD, and importantly Australia.
Capital market development workforce		
Minimise the cost of capital	N	Removing depreciation would reduce future income from investments in property (due to reduced future income streams) and lower NPV (due to lower cash-flows in early years). This means the required rate of return for a given investment would rise.
Capital flows to most valuable uses	N	This would create an artificial distortion to invest in other forms of assets (such as plant and machinery) relative to property. This is against the intent of a level playing field for all investments.
2025 Taskforce		
Sharpening private incentives to invest, to save and to work	N	Removing depreciation reduces the incentive to invest, as it lowers the future stream of income from the asset.
Minimising the regulatory obstacles the government puts in the way	-	Na
Managing the public sector's own huge assets much more effectively	-	Na
Source: NZIER		

3. Imposing a low-rate land tax

“A land tax is a highly efficient tax mechanism which could be introduced as part of a package of reforms to the New Zealand tax system.” (Policy advice division, IRD and The Treasury, 2009).

A land tax is only efficient if it is applied broadly and uniformly. In the event of exemptions, the tax ceases to be efficient and becomes distortionary with economic costs. While it may begin as a broad and exemption-free tax, New Zealand’s long history of land taxes shows (Figure 5) that tinkering and changes are difficult to resist.

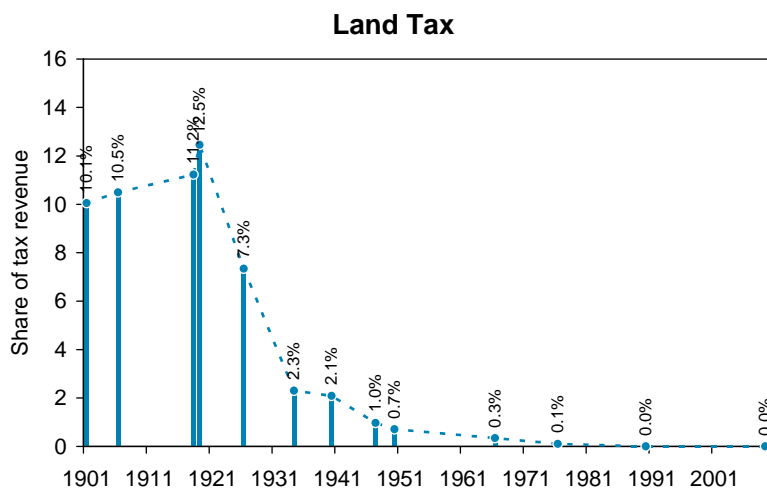
A land tax would be a burden for the asset-rich-cash-poor segments of society, including farmers, lwi and retirees. A greater immediate concern would be a loss of land value and its impact on the banking system. At least 2/3 of bank lending is to land based industries and residential property, so the impact on availability and cost of credit and the economy may be large.

The land tax only stacks up under very special circumstances. Looking at it objectively against the criteria set out by the TWG, CMD Taskforce and the 2025 Taskforce, it seems unlikely that the main criteria can be satisfied over a reasonable timeframe.

3.1 Long history of land taxes

New Zealand has a long history of land taxes. These became smaller through time as other taxes were introduced and exemptions were created. Even if introduced in a efficient fashion now, it is unclear if it can be politically sustainable.

Figure 5: New Zealand Land tax through time



Source: McKay, L, April 1978, New Zealand Universities Law Review, Volume 8, "Historical aspects of the estate tax"

3.2 Assessment against criteria

The land tax meets the TWG's criteria only under very special circumstances. In particular, the policies need to be applied broadly and uniformly. Otherwise, distortions create economic loss. Even if enacted as such in the beginning, it is unclear if it can remain free from political interference in the future.

More worrying is the prospect of land value declines and the impact on the banking sector. This could impact on the cost and availability of capital and restrain economic growth for a protracted period of time.

Group and criteria	Meet?	Comments
Tax working group		
Efficiency and growth	N	A land tax would be efficient only if applied uniformly. This is unlikely over the medium term given vote-sensitive and asset-rich-cash-poor segments such as farms, lwi and retirees. In the presence of exemptions the tax would be inefficient and distortionary.
Equity and fairness	N	There could be a large impact on the banking sector, with at least 2/3 of their loans to land based industries and housing. This could raise the cost and availability of capital, weighing on future economic growth. It would be equitable and fair only if applied uniformly. However, it would adversely impact on the groups identified above. In the presence of exemptions, as happened historically, the tax would not meet this criterion.
Revenue integrity	Y	If properly implemented revenue integrity should be maintained.
Fiscal cost	Maybe	The impact is ambiguous, as it would depend on the rate of tax, if the tax is a deductible expense and how much land prices fall. There may also be wider financial and economic ramifications which cannot be predicted accurately.
Compliance and administration cost	Maybe	Would likely reduce compliance and administration.
Coherence	N	Only targets one class of wealth and is thus not coherent.
Capital market development workforce		
Minimise the cost of capital	N	Declines in land prices could impact on the banking sector and thus the cost of capital.
Capital flows to most valuable uses	N	Creates a distorting incentive to hold wealth in assets other than land.
2025 Taskforce		
Sharpening private incentives to invest, to save and to work	N	Creates a distorting incentive to hold wealth in assets other than land. Does not give specific incentives to invest, save or work.
Minimising the regulatory obstacles the government puts in the way	-	Na
Managing the public sector's own huge assets much more effectively	-	Na
NZIER, TWG Land tax background paper, Sep 2009		

Appendix A - Removing all depreciation

Figure 6: Removal of ALL depreciation scenario

Data in \$b	2008 actual	Without depreciati on	Change	
			%	\$b
Income	561	561	0%	0
Expenses	513	494	-4%	-19
Depreciation	19	0	-100%	-19
Other expenses	494	494	0%	0
Taxable income	47	67	41%	19
Statutory tax rate	30%	30%	-	-
Cash income pre tax	67	67	0%	0
Tax paid	14	20	41%	6
Net cash income	52	47	-11%	-6
Effective marginal tax rate	30.0%	42.2%	12%pt	-

Source: Statistics NZ, NZIER

Figure 7: Tax effect of depreciation removal by industry

Industry	Change in -		Effective tax rate	
	Tax bill	Net cash income	Scenario	Increase
Education and Training	139%	-20%	72%	42%pt
Information Media and Telecommunications	99%	-18%	60%	30%pt
Public Administration and Safety* Electricity, Gas, Water and Waste Services	94%	-17%	58%	28%pt
Transport, Postal and Warehousing	82%	-16%	54%	24%pt
Retail Trade and Accommodation	72%	-15%	52%	22%pt
Agriculture, Forestry and Fishing	67%	-15%	50%	20%pt
Manufacturing	61%	-14%	48%	18%pt
Arts, Recreation and Other Services	57%	-13%	47%	17%pt
Construction	46%	-12%	44%	14%pt
Rental, Hiring and Real Estate Services	46%	-12%	44%	14%pt
Mining(1)	44%	-12%	43%	13%pt
Health Care and Social Assistance	44%	-12%	43%	13%pt
Wholesale Trade	41%	-11%	42%	12%pt
Professional, Scientific, Technical, Administrative and Support Services	21%	-7%	36%	6%pt
Financial and Insurance Services	20%	-7%	36%	6%pt
Total	4%	-2%	31%	1%pt
Total	41%	-11%	42%	12%pt

*2007, as 2008 year the sector made a loss, resulting in distorted calculations

Source: Statistics NZ, NZIER

Appendix B - References

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