Tax Working Group

Te Awheawhe Tāke

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This paper contains advice that has been prepared by the Tax Working Group Secretariat for consideration by the Tax Working Group.

The advice represents the preliminary views of the Secretariat and does not necessarily represent the views of the Group or the Government.

Coversheet: Potential revenue-reducing options

Position Paper for Session 14 of the Tax Working Group
19-20 July, 2018

Purpose of discussion

Decide which, if any, revenue-reducing policies should be recommended in the interim report.

Consider how to address the Group's Terms of Reference with regard to promoting "the long-term sustainability and productivity of the economy" and "the right balance between supporting the productive economy and the speculative economy".

Key points for discussion

We consider there are four key decisions for the Group:

1. What objectives does the Group wish to prioritise when considering revenue negative reform?
2. What specific measures does the Group wish to recommend within these objectives?
3. How does the Group wish to present these recommendations in its interim report?
4. How should the interim report address the role of tax in promoting "the right balance between supporting the productive economy and the speculative economy"?

Recommended actions

We recommend that you:

a **note** there are a range of revenue-reducing tax policy options that could be funded from revenue-raising measures.

b **note** that the analysis in this paper has been written on the basis that a capital gains tax is the most significant revenue-raising policy that the Group is currently considering.

Social and human capital – progressivity and labour supply

c **note** that transfers are generally more effective than tax changes in targeting the income adequacy of the lowest income households.

d **note** that the following revenue-reducing option could support a distributional or social capital objective:
   a. increasing progressivity through income tax reductions (rates and/or thresholds) at the low-to-middle parts of the income distribution

Financial/physical capital – productivity

e **note** that the following revenue-reducing options (funded by base broadening) would likely have the greatest benefits for productivity:

   i. reductions in effective tax rates on business investment by reintroducing depreciation deductions for commercial, industrial, and multi-unit residential buildings;
   ii. reducing disincentives to take risk by reforming loss continuity rules; and
   iii. reductions in marginal tax rates on individual income.

f **note** that the case for allowing depreciation deductions for buildings is greater if a capital gains tax is introduced.

g **note** that there is international evidence that buildings depreciate and that this evidence is strongest for industrial and commercial buildings.

h **note** that inflation indexation of interest income, interest expenses, depreciation and inventory would be a significant reform that could have efficiency benefits, but would need considerable further work to fully assess its benefits and costs.

i **note** that the Group has previously agreed to recommend the following revenue-reducing measures to support retirement saving:

   i. providing an exemption from employer superannuation contribution tax (ESCT) for employer contributions to KiwiSaver for employees with income of less than $48,000; and
   ii. reduce KiwiSaver PIE rates for lower tax rates by five percentage points.

Natural capital – supporting just transitions

j **note** that the Group has previously agreed to recommend that environmental tax revenues should be recycled to support just transitions and enhance natural capital.

Reducing taxes on future generations

k **note** that, as an alternative approach, the government could save additional revenues to enable lower taxes on future generations (eg, investing additional tax revenues in the New Zealand Superannuation Fund).

Interim report

l **indicate** which of the below revenue-reducing options should be recommended in the interim report:

Income tax and GST rate and threshold changes

i. Reduce income tax rates and/or increase income tax thresholds
ii. Annually adjust income tax thresholds for inflation
iii. Decrease GST rate

Business tax and savings changes

iv. Reintroduce depreciation deductions for commercial, industrial, and multi-unit residential buildings
v. Relax loss continuity provisions to allow losses to be carried forward in more circumstances
vi. Inflation index the tax system (interest income, expenses, capital assets, depreciation and inventory)
vii. CAANZ proposal for overhaul of small business taxation (turnover tax and cashflow based tax)
viii. Other compliance cost reductions
ix. Accelerated depreciation including expensing for equipment
x. Reduce company tax rate

Reducing taxes on future generations

xi. Save revenue from a capital gains tax to reduce taxes on future generations (eg, by investing revenues in the New Zealand Superannuation Fund).

m **agree** that if the Group recommends a capital gains tax to also recommend reform of the treatment of black-hole expenditure to allow it to be deductible over time and consider removal of loss ring-fencing for rental properties.

n **indicate** how the Group would like to address the Group's Terms of Reference with regard to promoting "the long-term sustainability and productivity of the economy" and "the right balance between supporting the productive economy and the speculative economy".

Potential revenue-reducing options

Position Paper for Session 14
of the Tax Working Group

July 2018

Prepared by the Inland Revenue Department and the New Zealand Treasury

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Executive Summary

This paper provides advice on a range of potential tax changes with a negative fiscal impact. The Group requested analysis of this list of options at its meeting on 29 June. This advice is provided to support consideration of what proposals the Group wishes to recommend in its interim report.

The scope for revenue-reducing options will depend on fiscal objectives and the combined impact of any tax measures on the fiscal outlook. The advice in this paper has been written on the basis that a capital gains tax is the most significant revenue-raising policy that the Group is currently considering. An illustrative fiscal projection is provided that is preliminary and subject to considerable uncertainty.

There are trade-offs in choosing which revenue-reducing measures to pursue. The fiscal impact of many of the measures would mean that only some could be implemented within the Government's fiscal objectives if the Group recommended a capital gains tax. As a result, the Group will need to prioritise its objectives. Given the gradual build up in additional revenue from a capital gains tax, consideration will also need to be given to the phasing of any revenue negative measures.

There are choices regarding how to achieve different objectives. In some cases policies beyond the tax system, for example regulation, welfare transfers, or subsidies will be better options than tax policy for achieving specific public policy objectives.

The Group will need to decide whether its recommendations to Government will be in the form of a set of independent recommendations, a recommended package of policies or multiple potential packages.

Appendix A brings together material on productivity and the balance between the productive and speculative economies. Some of this material could be used in the interim report. The remaining appendices provide detailed assessments of the policy options considered.

Some of the information provided in these papers, in particular the fiscal and distributional impacts should be considered preliminary and prepared for the purpose of discussion. If the Group wishes to recommend a specific option, the Secretariat will undertake further quality assurance of the impacts of that option.

Improving social capital and human capital – Progressivity and labour supply

Whether to recommend tax changes to support lower income households is a value judgement about how progressive the tax system should be and how much tax particular individuals should pay. The primary consideration for specific tax rate or threshold changes is whether these are the highest value measures for a given fiscal cost. Other tax measures may be a higher priority, and there may be non-tax measures that are more effective than tax measures at achieving specific goals.

The Secretariat considers that tax reductions are not well targeted towards providing support to households with persistently very low incomes and instead transfers would be more effective.

One possible objective of tax reductions is to improve incomes of target low-middle income earners and at the same time provide additional benefits to labour supply, savings and productivity. If this is the objective the Secretariat considers the best *tax* measures available are likely to be increases in the first and second income tax thresholds or decreasing tax rates on the low-to-middle tax brackets (eg, the 17.5% rate).

Taxes on future generations could be reduced through Government saving of additional tax revenue (e.g., by investing additional revenues into the New Zealand Superannuation Fund).

In addition, the Group has previously agreed to revenue negative measures to support retirement saving of those low and middle incomes.

Financial/physical capital - Productivity

If the Group wishes to recommend changes to improve productivity, we recommend focusing on areas where effective tax rates for investment are higher than the statutory rate. We consider effective tax rates in these areas are currently likely resulting in efficient investments not being made by businesses and investors. Removing these distortions would have a double benefit of increasing investment as well as improving investment allocation.

Potential measures include reinstating depreciation for commercial, industrial, and multi-unit residential buildings and the relaxation of loss-continuity rules. The case for allowing depreciation deductions is stronger if a capital gains tax is introduced.

Income tax reductions that focus on reducing marginal tax rates, would also have positive impacts for productivity. However, the fiscal cost and regressive impact of this option may be of concern to the Group.

In the longer-term, inflation indexing the tax system is a significant reform that could have positive efficiency benefits, however this option is complex and requires further assessment of its benefits and costs. A proposal for inflation indexation would require substantial policy work and is not feasible to be implemented in the short-term. If the Group wants to make recommendations regarding inflation indexation we would suggest the Group recommend the Government monitor international developments or undertake further work on the issue.

Natural capital – supporting just transitions

The Group has previously agreed to recommend that environmental tax revenues should be recycled to enhance natural capital and support just transitions. We understand that Marjan van den Belt will report back to the Group at a later stage on this.

1. Introduction

1.1 Purpose

1. This paper provides advice on a range of potential tax changes with a negative fiscal impact. The Group requested analysis of this list of options at its meeting on 29 June. This advice is to enable consideration of what proposals the Group wishes to recommend in its interim report.

1.2 Content and scope

2. The advice in this paper has been written on the basis that the Group is considering recommending capital gains tax. For the sake of illustration we have used previously provided modelling regarding the fiscal impact of a capital gains tax.

3. The paper provides a broad overview that includes some revenue negative options provided to date, including some that the Group has indicated it is unlikely to recommend. The objective is to provide these to compare with other similar measures and provide consistent assessment criteria to inform discussion.

4. The options considered are those that the Group requested further analysis on. There are other options for more radical reform of the tax system that are beyond the scope of this paper (e.g. dual income tax system).

5. Part 2 of this paper provides the fiscal context including the Government's revenue objectives and what scope there is for revenue reducing options within this strategy and the Group's Terms of Reference.

6. Part 3 of this paper summarises the framework and criteria for assessment that have been used for the measures considered in this paper.

7. Part 4 of this paper provides a summary table of the revenue-reducing proposals and their impacts.

8. Part 5 outlines potential packages for reform.

9. Further analysis of particular measures is provided in the attached additional papers:

   - Appendix A – Productivity, the productive and speculative economy
   - Appendix B – Tax rate and threshold changes
   - Appendix C – Building depreciation
   - Appendix D – Loss continuity
   - Appendix E – Inflation indexing the tax system
   - Appendix F – Compliance cost reductions
   - Appendix G – Accelerated depreciation
   - Appendix H – Reducing taxes on future generations
   - Appendix I – Changes contingent on a capital gains tax

10. A separate paper on company tax rate issues – review of Secretariat modelling has also been provided to the Group in a separate paper.

11. Some of the information provided in these papers, in particular the fiscal and distributional impacts should be considered preliminary and prepared for the purpose of discussion. If the Group wishes to recommend a specific option, the Secretariat will undertake further quality assurance of the impacts of that option.[1]

[1] Access to the Household Economic Survey data was provided by Statistics New Zealand under conditions designed to give effect to the security and confidentiality provisions of the Statistics Act 1975. The results presented here are the work of Treasury, not Statistics New Zealand.

2. Fiscal context

12. It is essential to consider the fiscal context when setting tax policy, given the importance of revenue to the Government's budget.

13. The Government's fiscal strategy is based around five Budget Responsibility Rules:
    - Deliver a sustainable operating surplus across an economic cycle.
    - Reduce the level of net core Crown debt to 20 per cent of GDP within five years of taking office.
    - Prioritise investments to address the long-term financial and sustainability challenges facing New Zealand.
    - Take a prudent approach to ensure expenditure is phased, controlled and directed to maximise its benefits. The Government will maintain its expenditure to within the recent historical range of spending to GDP ratio.
    - Ensure a progressive taxation system that is fair, balanced and promotes the long-term sustainability and productivity of the economy.

14. The Group's Terms of Reference include an objective that the tax system supports a sustainable revenue base to fund government operating expenditure around its historical level of 30 per cent of GDP.

15. The Government's *Fiscal Strategy Report*, released as part of Budget 2018, includes projections for revenue, the operating balance and net debt over a fifteen year horizon. Consistent with the Government's fiscal objectives, projected levels of tax revenue are sufficient for continued operating surpluses and net core Crown debt stabilising at below 20% of GDP, while expenses as a share of GDP are maintained at below the historical average.

16. Projected tax revenues are sufficient to fund operating expenses at around their historical average. Government core operating expenses have averaged around 30% of GDP for the past 20 years, and are forecast to be 28.5% of GDP in 2018/19. The Government's fiscal projections assume future governments can continue to manage overall Crown expenses at around this level. However, fiscal pressures from demographic change and health cost growth will make this challenging to maintain over coming decades.

17. Crown tax revenue is currently 27% of GDP. It is forecast to rise to its long-term average of 28% of GDP by 2021/22 largely owing to fiscal drag. Overall core government revenue, including tax and non-tax revenues, is forecast to be 30% of GDP in 2021/22. The fiscal projections assume a stable tax-to-GDP ratio from 2022/23, so that there is no fiscal drag in the long-term projections (ie, the projections assume future governments will adjust income tax thresholds over time as incomes rise).

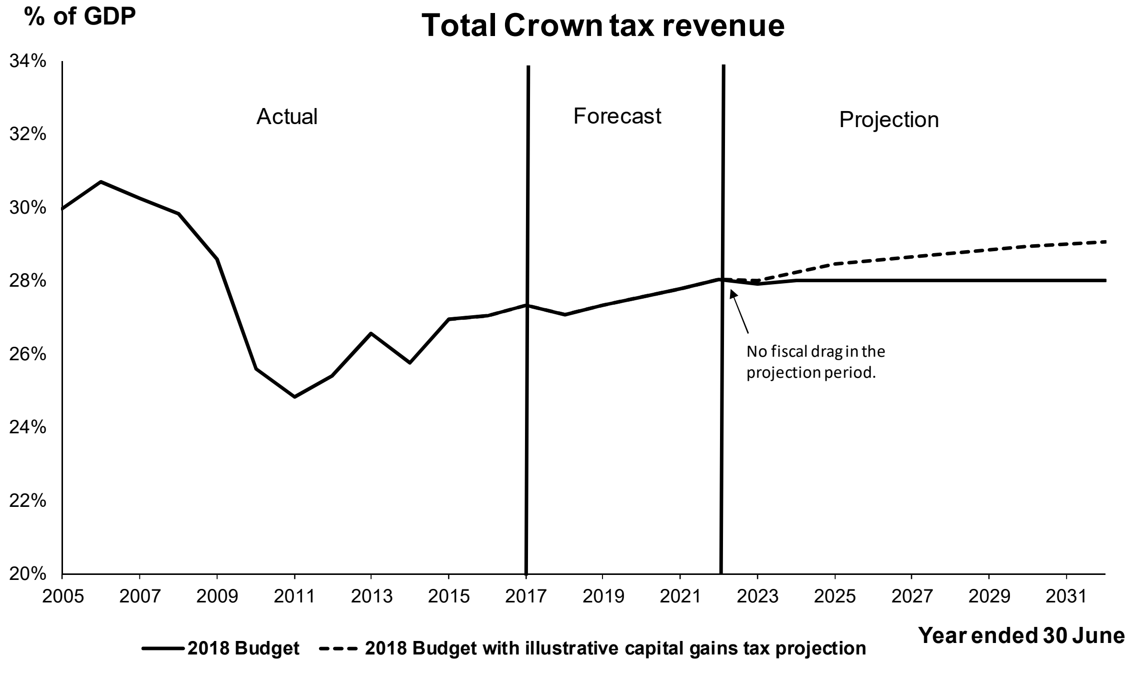
18. The impact of tax reform on the fiscal outlook will depend on the combined impact of tax measures implemented. Higher tax revenue from revenue-raising policy measures (eg, from the introduction of a capital gains tax) could be used to either:
    a. fund other revenue-reducing tax policies to maintain levels of tax revenue;

b. fund higher government expenditure (including tax credits and other transfers); or
c. enable higher government saving (eg, higher contributions to New Zealand Superannuation Fund) which would reduce taxes on future generations.

19. The Group's Terms of Reference suggest that tax revenues should be broadly maintained at around the levels currently projected. Nevertheless, a moderate increase in revenue and expenses could also be broadly consistent with maintaining expenses around their historical level (since core expenses are currently 28.5% of GDP, which is below the historical average level of 30% of GDP). In the long term, additional revenue could be used to fund higher government expenditure to meet the costs of an aging population and other long-term fiscal pressures.

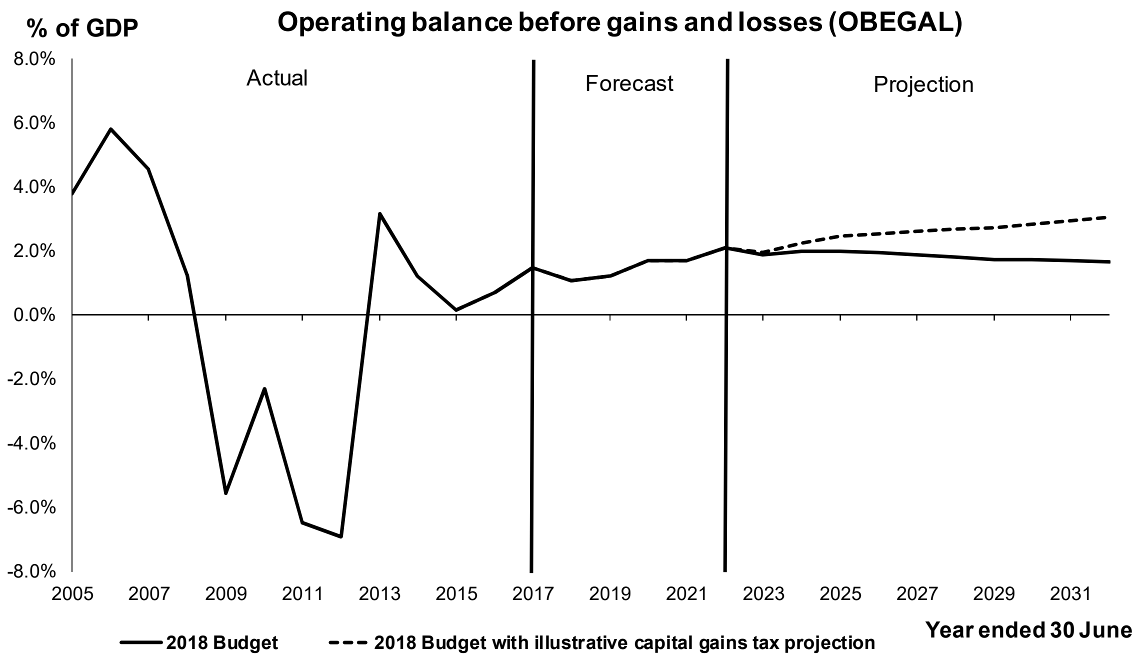
2.1 Capital gains tax revenue

20. The charts below show the Government's fiscal projections for tax revenue and the operating balance (from the 2018 *Fiscal Strategy Report*) and an illustrative scenario of introducing a CGT in 2022.[2] A CGT is considered as the most significant revenue-raising policy that the Group is currently considering. A CGT could be expected to result in a material amount of additional tax revenue in the long term, but it would take a long time to reach these levels.



Source: The Treasury

[2] For indicative purposes, the charts show a projected capital gains tax revenue with implementation in the projection period (from 2022/23). Projections are preliminary and subject to further refinement of assumptions. The asset base may include some government-owned land and buildings owing to data limitations, which may overstate the estimates. The starting asset base is based on latest actual data and has not been uplifted, which may understate revenue.



Source: The Treasury

21. The secretariat's illustrative scenario assumes a realisation-based capital gains tax (excluding the family home) is introduced and its revenue builds up to around 1% of GDP over a decade. This illustrative revenue projection is subject to much uncertainty, will depend on the design details of any capital gains tax and does not factor in behavioural responses by households and firms. Actual revenue from a capital gains tax would be volatile owing to asset price fluctuations and other economic developments.

22. The Secretariat's modelling of the revenue from a capital gains tax is below.

Tax revenue generated by a capital gains tax[3]

	Year 1	Year 5	Year 10
Nominal dollars ($ billion)	0.3	2.9	5.7
Percent of GDP	0.1	0.8	1.3

23. There are many assumptions in this modelling of a realisation-based capital gains tax, including:

(i) all asset classes appreciate at a nominal rate of 3%;
(ii) only gains from the date of introduction are taxed; and
(iii) full marginal income tax rates are applied.

[3] The estimates are preliminary and subject to further refinement. The revenue figures are slightly increased from that provided in the Secretariat's previous paper on the taxation of capital income as the value of rural land has been corrected for a data error. Revenue is expressed in nominal dollars (ie, not adjusted for inflation).

24. In addition, important related issues when considering a capital gains tax are the treatment of capital losses, black-hole expenditure and loss ring-fencing for rental properties. There are associated fiscal impacts for these. The expected fiscal cost of allowing deductions for black-hole expenditure alongside a capital gains tax is expected to be approximately $50m per annum. When fully phased in, loss ring-fencing is expected to raise $190m per year and removing it would have this same fiscal cost. Further information on this in Appendix I.

25. The paper considers a range of revenue-reducing options. An alternative use of additional revenues would be for the government to save the revenue to enable lower taxes on future generations. Appendix H describes an option in which additional capital gains tax revenues are invested into the New Zealand Superannuation Fund. Whether to reduce taxes on future generations, and increase taxes for current taxpayers, requires a value judgement and comparing that with other potential measures.

Previous decisions

Savings

26. At its last meeting the Group agreed to recommend the following measures with negative fiscal impacts:
    - providing an exemption from ESCT for employer contributions to KiwiSaver for employees with income of less than $48,000; and
    - reducing KiwiSaver PIE rates for lower tax rates by five percentage points.

27. These changes have an estimated fiscal cost of approximately $150 million and $35 million per annum respectively. As the Group has previously considered changes to retirement savings, these are not considered further in this report other than consideration of inflation indexation of the tax system.

Environment

28. The Group previously agreed to recommend that revenue from any environmental taxes should be recycled to support just transitions and enhance natural capital. The Group also considered that the interim report should consider FBT exemptions for public transport. We understand that Marjan van den Belt will report back to the Group at a later stage with further analysis.

3. Assessment framework

29. The Group previously agreed to consider tax proposals against the established principles of a good taxation system as well as the Living Standards Framework. The approach was:
    - The Living Standards Framework is used to help frame its assessments of the performance of the tax system as a whole, particularly with a view to identifying the strengths and weaknesses of the system over time.
    - Individual proposals for tax reform are assessed against the established principles of *efficiency and growth, equity and fairness, revenue integrity, fiscal cost, compliance and administration cost,* and *coherence.*
    - The Living Standards lens is also applied to individual proposals, to ensure that any broader considerations which have not been captured by the established principles, are brought to the Group's attention.

30. This approach has been taken in the following analysis. However, the pros and cons in the following table are on an exceptions basis and we have only included factors which are significant for particular options.

31. The context of potentially introducing a CGT is relevant. Increasing the taxation of capital income is likely to increase effective tax rates on some investments, and thereby reduce overall levels of investment. By itself, this is likely to have a negative impact on productivity and economic growth. However, base broadening could enable lower tax rates or other revenue-reducing measures to mitigate these effects.

	Benefits	Costs	Distributional impact	Fiscal impact[4]	Living standards implications	Secretariat recommendation
Reducing income tax rates and/or increase thresholds	*Fairness:* A different income tax structure may be considered fairer, but depends on the desired distributional outcomes and which rates and/or thresholds are adjusted. *Efficiency:* Income tax rates influence returns to work, saving and investment. However benefits likely to be modest if not materially reducing marginal tax rates.	*Fairness:* Depends on option chosen. Given that no tax rates rise, all options considered benefit high income households at least as much as low-income households in dollar terms.	Changes targeted to low income households would be *progressive*. However, total distributional impact is expected to be modest.	Range of fiscal costs depending on specific measure. Paper considers changes that cost approximately $2 billion per annum.	*Social capital:* Reduced tax costs for some households may be considered to improve social capital. *Financial/physical capital*: Reducing income tax rates reduces tax on savings an investment. This would increase financial/physical capital. *Human capital:* Decreasing income tax rates increases incentives for individuals to participate in labour-force and improve human capital.	Whether to reduce taxes for progressivity, social capital or productivity requires value judgements. What specific measures to use depend on what the Group's goal is: • *Social capital and targeting towards lowest income households:* Tax may not be the most effective instrument and welfare transfers would have greater impact on target population. • *Social capital, human capital and targeting towards low-middle income earners (for example a full-time earner on minimum wage):* One possible objective of tax reductions is to improve incomes for target low-middle income earners and providing additional benefits to labour-supply, savings and productivity. If this is the objective the Secretariat considers the best *tax* measure available is likely to be increases in the first and second income tax thresholds or decreasing tax rates on the low-to-middle tax brackets (eg, the 17.5% rate). • *Financial/physical capital, human capital and targeting towards productivity:* Changes to top personal rates likely to have greatest impact, but would reduce progressivity and therefore potentially not fit within the Group's goals.
Annually adjust income tax thresholds for inflation	*Fairness*: Prevent 'bracket creep' which decreases progressivity. *Efficiency:* Improvements in labour-supply and investment. However, this impact is expected to be modest.	*Fairness:* Benefits high income households more than low-income households in dollar terms.	Roughly *proportional.*	Adjusting thresholds for inflation from 2010 to 1 April 2019 has fiscal cost of $1.7b per annum). Annual increases to thresholds for inflation have an approximate fiscal cost of $300m per annum (assuming 2% inflation).	*Social capital:* May impact perceptions of fairness of the tax system. *Financial/physical capital*: Reducing income tax rates reduces tax on savings and investment. This would increase financial/physical capital. *Human capital:* Decreasing income tax rates increases incentives for individuals to participate in labour-force and improve human capital.	If goal is to improve progressivity or to improve productivity this is unlikely to be the best targeted measure for either. We consider the case for inflation indexation depends primarily on whether there are concerns that bracket creep is non-transparent increase in taxation. Whether this is of sufficient concern is a value judgement.
Decrease GST rate	*Fairness:* Reducing a tax which is regressive on an annual income basis but broadly proportional on an expenditure basis *Efficiency:* GST is likely to be a relatively efficient tax. Nonetheless, some increase in incentives to work. Benefits likely to be modest.	*Fairness:* Benefits high-income households more than low-income households in dollar terms. Provides windfall gain to wealth.	Distributional impact depends on distributional measure chosen. A GST rate reduction is: • *Progressive* when measured against current income • *Proportional* when measured against lifetime income or expenditure • Likely to benefit *those with high wealth*	Decreasing GST rate to 13.5% costs approximately $2 billion per annum.	*Social capital:* Reduced tax costs for some households may be considered to improve social capital.	Do not recommend. Secretariat considers that GST is likely to be a relatively efficient tax. Also income tax changes or welfare transfers would achieve distributional goals better than this measure. A GST rate reduction provides greater benefit to highest income and wealthiest households compared with targeted income tax reductions. Income tax rate reductions also reduce taxation of savings which would help address concerns from Group about taxes on savings.
Reintroduce depreciation on industrial, commercial, and multi-unit residential buildings	*Efficiency:* Reduces high effective tax rates for investments in industrial, commercial and multi-unit residential buildings. Improves productivity and investment decisions. *Fairness:* Unclear distributional impact in case of commercial and industrial. May be considered to improve horizontal equity	*Fiscal cost:* Option needs to be considered alongside what other measures could be done with the same fiscal cost.	Difficult to measure. Benefits investors in buildings. Wider benefits from productivity improvements and some benefits of increased investment passed on to consumers. Depreciation of multi-unit residential housing could increase housing supply and boost housing affordability	Approximately $915m per annum for industrial, commercial, and multi-unit residential buildings with 3% diminishing value depreciation rate.	*Financial/physical capital:* Improvements to investment in New Zealand and productivity. Allowing depreciation deductions for some residential buildings would increase housing supply. This could have positive impacts on *financial/physical capital.*	Recommended. We consider that of the options outlined this is the best option for improving productivity for a given fiscal cost. Option will remove current over-taxation of buildings with associated distortions. This will improve investment decisions and could have positive impacts to associated issues of housing supply and seismic strengthening. Case for allowing deductions for depreciation is potentially greater with introduction of a capital gains tax. This is because a capital gains tax would capture any actual economic depreciation or appreciation on disposal.

[4] Fiscal impacts are for a 1 April 2019 application date. Note that to compare these figures with potential capital gains tax revenue after five years, these figures would need to be uplifted by around 30 percent to reflect forecast inflation and income growth.

	Benefits	Costs	Distributional impact	Fiscal impact[4]	Living standards implications	Secretariat recommendation
Relax loss continuity provisions to allow losses to be carried forward in more circumstances	*Efficiency:* Reduces current tax distortion against risk-taking and impediment to firms that need to grow issuing new capital	*Revenue integrity:* Creates increased risk of loss-trading. Risks can be managed through careful design.	Difficult to measure. Benefits investors in risky businesses. Likely to particularly benefit start-ups.	\$30m-\$60m per annum based on several assumptions. Cost higher if poorly designed.	*Financial/physical capital:* Improves investment decisions. *Social capital:* If rules are not tightly designed, risk of loss trading could harm trust in government.	Recommended. New Zealand's current rules are likely too restrictive and having negative impacts on risk-taking. However, requires further development and consultation to address revenue risks.
Inflation indexing the tax system	*Efficiency:* Reduce current high effective tax rates on savings and investment. Decrease distortion between owner-occupied housing and other investments. Increase private savings and investment. *Fairness:* Improves horizontal equity as reduces over- and under-taxation of assets reduced.	*Compliance and administration costs:* Highly complex with high compliance and administration costs. Few countries have implemented inflation indexation and those that did were only temporary in high inflation environment. *Revenue integrity:* Creates arbitrage risks.	Difficult to measure. Benefits for investment income and capital assets likely to mainly benefit high income households. Flow on productivity benefits difficult to measure.	Difficult to measure. Estimate of impact assets and liabilities has cost at \$220m but we consider the reliability of this estimate to be very low (this figure does not include the potential cost of inflation-indexing a capital gains tax). The actual fiscal impact could be significantly higher or lower. Would reduce potential revenues from capital gains tax.	*Financial/physical capital:* Increases investment and investment allocation. *Social capital:* Improves horizontal equity, but potentially decreases vertical equity.	Comprehensive indexation is not feasible to implement in the short term and is risky due to lack of international precedent. If Group wishes to make recommendations we suggest that they recommend the Government monitor international developments and consider comprehensive indexation further. We do not recommend partial approaches to indexation. These approaches have significant downsides including revenue integrity risks, distortions and increased cost of capital for businesses and such approaches may not significantly reduce compliance costs or improve fairness of tax rules.
CAANZ proposal for overhaul of small business taxation (turnover tax and cashflow based tax)	*Compliance costs:* Will reduce compliance costs for small businesses.	*Fairness:* Does not align with horizontal equity, effective tax rates will be different depending on level of expenditure and cash flows. *Efficiency:* Different effective tax rates will create distortions. Could create disincentive to growth. *Impact on social policy:* Changing definition of income potentially has negative impact on other social policies.	The options would predominantly benefit small businesses. However, it is impossible to determine whether the result would be progressive or not because that is dependent on the level of expenditure against the income and the income or wealth of the owner of the business, particularly in respect of the micro business proposal.	Neutral if compulsory and right rate set. Loss of revenue if optional or low rate set.	*Financial/physical capital:* Compliance cost reduction would supports small businesses and potentially help them to grow. Negative efficiency impacts potentially impede small business growth. *Social capital:* Impact on social policy products likely to have implication for social capital.	Do not recommend. We do not consider that the compliance cost savings would outweigh the costs. If Group wishes to undertake measures to reduce compliance costs, we consider that in short-term other options outlined for simplification are preferred. In longer-term greater use of accounting software provides better opportunities for reform.
Accelerated depreciation including expensing for equipment	Would provide a subsidy to increase the capital stock.	*Efficiency:* On net, option reduces efficiency. Option distorts investment allocation decisions and will reduce productivity and net welfare. *Fairness:* Results in effective tax rate for depreciable assets lower than statutory rate.	Difficult to measure. Benefits investors in depreciable assets (including overseas investors). Wider benefits and costs from increased investment and investment distortions.	Accelerated depreciation at 20% has cost of \$160m for 2019/20. This cost increases in subsequent years up to \$350m in 2023/24. Partial expensing at 20% has fiscal cost of \$680m for 2019/20, with cost decreasing in subsequent years down to \$310m in 2023/24.	*Financial/physical capital:* Net reduction. Increases investment, but results in misallocation of investments. Net reduction in welfare. *Social capital:* Benefits one type of investor over others. This may negatively impact horizontal equity and perceptions of fairness.	Do not recommend If Group wants greatest productivity improving measure for a given fiscal cost we would recommend they focus on building depreciation and loss continuity provisions rather than accelerated depreciation. This option results in investments being made that do not make an economic return.
Reduce company tax rate	*Efficiency:* Increases investment and productivity. However, impact on net welfare expected to be marginal compared to alternative policy options at this time. Reduces incentives to move businesses offshore.	*Efficiency:* Reduction in company tax rate reduces tax on economic rents. *Revenue integrity:* Creates greater opportunity to shelter personal income in companies.	Difficult to measure. Directly benefits owners of companies (including foreign investors). Indirectly benefits other New Zealanders through increased investment and productivity.	\$315m per annum for a one percentage point reduction.	*Financial/physical capital:* Improvements to investment in New Zealand and productivity. *Social capital:* Revenue integrity costs may reduce integrity of tax system, impact on fairness is debateable.	Do not recommend at this time, but continue to closely monitor. We consider that, on balance, will have lower net benefits to New Zealand than alternative options. Would decrease integrity of tax system due to rate misalignment.
Black-hole expenditure and loss ring-fencing	These options should be considered in the development of a capital gains tax. As a result, costs and benefits are contingent on this. Black-hole expenditure is expected to have a fiscal cost of not more than \$50m per annum. Removing loss-ring fencing would cost approximately \$190m per year once fully implemented.					Recommend issues be considered further as part of potential introduction of a capital gains tax.

Administrative implications

32. Of the options outlined the two with the most significant administrative implications for Inland Revenue are the options to inflation index the tax system and the CAANZ proposal for an overhaul of small business taxation. These could have significant administrative implications that would require further consideration. In particular administrative implications may be greater with the cumulative impacts of implementing these at the same time as other changes the Group may wish to recommend.

5. Potential fiscally neutral packages of options

5.1 Options assessment

33. The Group may wish to provide its recommendations to Government will be in the form of a set of independent recommendations, a recommended package of policies or multiple potential packages.

34. The Group may also wish to have regard to providing the Government with flexibility across its tax and expenditure settings. For example, changes to transfer settings might be more effective than tax changes to achieve a particular distributional goal or improve the tax-transfer interface.

35. The Group may wish to consider the fiscal parameters, including whether any recommended package should be fiscally neutral and over what time frame. The Group has agreed to recommend that revenues from environmental taxes should be recycled to support just transitions. As a result, if the Group wishes to recommend fiscally neutral packages, this will be done predominantly through revenue from a capital gains tax.

5.2 Illustrative options

36. In order to stimulate discussion among the Group, the following illustrative packages could be considered (assuming these options could be funded by base broadening through a capital gains tax):

- Social capital and human capital package
    - Income tax reductions focusing on low to middle tax rates or increasing the first two income tax thresholds;
    - Ensure sufficient revenue to enable Government to provide greater assistance to low income households through the welfare system.
- Productivity package
    - Reintroduce building depreciation for commercial, industrial and multi-unit residential buildings;
    - Relax loss-continuity rules.

37. These potential packages would be in addition to previously recommended revenue negative proposals to PIE rates and ESCT, as well as consideration of the fringe benefit tax rules for public transport.

Glossary

Administration costs: The costs for the Government in administering the tax system.

Arbitrage: The practice of profiting from differences that arise from the ways transactions are treated for tax purposes.

Average tax rate: The tax rate a person pays when you add all sources of taxable income and divide that number by the total tax paid.

Balance sheet: A statement of the assets, liabilities, and capital of a business or other organisation at a particular point of time.

Black-hole expenditure: Business expenditure that is expected to result in an economic cost to a taxpayer, but is neither immediately deductible for tax purposes, nor deductible over time.

Bracket creep/Fiscal drag: Where higher tax rates apply to taxpayers as their incomes increase over time due to inflation, but tax thresholds are held steady.

Breach of continuity: A situation where a company has a significant change of ownership. For New Zealand tax purposes this is defined as being more than 51% of the voting interest of the company changing.

Capital income: Income that is a return on invested capital (that is, income from owning something rather than personal effort) such as interest, dividends, rental income and the return on capital invested in a business.

Compliance costs: The expenditure of time or money for individuals and other taxpayers in complying with the tax rules. This are the costs incurred in complying and paying taxes that are above the amounts of tax paid to the Government.

Cost of capital: The cost of making a specific investment. This will usually be the rate of return that could have been earned by putting the same money into a different investment with equal risk.

Derivative: A financial security with a value that is reliant upon or derived from an underlying asset or group of assets.

Depreciation: A fall in the market value of an asset. This can be caused by physical deterioration and depreciation due to obsolescence or other factors.

Economic incidence: The individual or entity which bears the final burden of a tax (or receives the benefit of a transfer), after response effects, such as price and wage changes, are taken into account. This is distinct from the legal incidence of the tax or transfer.

Efficiency cost of taxation: Cost to society due to individuals, households, and firms making consumption and production choices in order to pay less tax, in the case where the tax is not intended to change behaviour deliberately (i.e. is not a *Pigouvian tax).*

Entertainment regime: A set of tax rules which limit the ability to claim a tax deduction for certain entertainment expenditure, such as food and drink provided at a work social event.

Externality: A consequence of an economic activity or transaction experienced by unrelated third parties.

Financial arrangement: An arrangement under which a person receives money, or money's worth, now in exchange for money, or money's worth, later.

Financial margin. The difference between revenue and expenses for financial institutions.

Fringe benefit tax: A tax on most non-cash benefits provided by employers to employees.

Goods and services tax (GST). A broad-based value-added tax on consumption in New Zealand.

Government operating expenditure: The Government's day-to-day spending (eg, salaries, welfare benefit payments, finance costs and maintaining national defence etc) that does not build physical assets for the Government. This is an accrual measure of expenses and includes items such as depreciation on physical assets. Also known as Core Crown expenses.

Horizontal equity: Horizontal equity refers to people in similar circumstances being treated in a similar way. For instance, by paying a similar amount of tax in the context of the tax system, or receiving a similar level of benefit in the transfer system.

Inflation: A general increase in prices and fall in the purchasing value of money.

Inflation indexing tax brackets: Where tax brackets are increased every year to account for the impact of inflation.

Inflation indexing tax system: Where the tax system is comprehensively adjusted for inflation so that only investment returns, and losses, that are greater than the inflation rate are taxable.

Legal incidence: The individual or entity legally liable to pay a tax or receive a transfer bears the legal incidence of the tax or transfer. The legal incidence often differs from the economic incidence.

Loss-continuity: Rules that determine whether losses from a previous year can be applied in following years.

Loss trading: An arrangement where a taxpayer that has incurred losses attempts to transfer the losses to a taxpayer with taxable income so they are able to be used to reduce the other taxpayers tax bill.

Marginal effective tax rate: A theoretical measure of the tax rate on real, pre-tax income for investments that only just make economic sense.

Marginal tax rate: The rate of tax applied to the next dollar of income earnt.

Net worth: A persons assets minus liabilities.

Nominal income/expense: The cash amount of income or expense unadjusted for inflation.

Operating balance before gains and losses: The Government's revenue less expenses excluding the impact of gains and losses.

Productivity: The ratio of outputs to inputs in a firm, sector or economy. Labour productivity is usually measured as output per hour worked. Multi-factor productivity is the growth in output that cannot be explained by growth in inputs (labour, capital etc).

Progressive tax: A tax where those on higher incomes pay a greater proportion of their incomes in the tax.

Provisional tax: A system that requires income that does not have tax withheld at source to be paid in instalments over the year.

Real income/expense: The amount of income or expense adjusted for inflation.

Regressive tax: A tax where those on higher incomes pay a lesser proportion of their incomes in the tax.

Revenue integrity: A principle that the tax system should minimise opportunities for tax avoidance and arbitrage and provide a sustainable revenue base for the government.

Seismic strengthening: Expenditure to make buildings more resistant to earthquakes.

Tax cascade: A tax that is applied at multiple points in the supply chain without any deduction for the tax paid at earlier stages.

Tax thresholds: The income level at which a person pays a particular rate of tax.

Trading stock: Property owned for the purpose of selling or exchanging in the ordinary course of business.

Vertical equity: Vertical equity is the principle that people with low means should receive greater assistance than those with higher means, and that those with greater economic capacity should have a higher tax burden.