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.***

# An Introduction to Frameworks for Evaluating Tax Reform

*Discussion Paper for Session 2*
*of the Tax Working Group*

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

***The Tax Working Group will release its interim report containing its recommendations in September and the views of the Group will be informed by public submissions alongside Secretariat advice.***

February 2018

*Prepared by the Inland Revenue Department and the New Zealand Treasury*

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# 1. Introduction

1. This paper is intended to support a discussion on the Tax Working Group's preferred assessment framework for evaluating tax reform.

2. The discussion will be spread across the Working Group's meetings on Friday 9 February and Friday 23 February.

3. The purpose of the first meeting, on Friday 9 February, is to introduce two existing assessment frameworks that are relevant in a New Zealand public policy context:

   - The Treasury's *Living Standards Framework*.

   - An established set of principles that are commonly used in the design of tax policy.

4. The first meeting also provides an opportunity for Working Group members to raise any other considerations or frameworks that may be useful for subsequent analysis.

5. At the second meeting, on Friday 23 February, the Working Group will be invited to discuss and agree on its preferred assessment framework. The Secretariat will provide a separate paper in advance of that meeting to support the discussion.

# 2. Existing Assessment Frameworks

## 2.1 The role of an assessment framework

6. An assessment framework is a consistent set of principles or criteria against which policy options can be assessed, measured, and ranked. Establishing a coherent and rigorous assessment framework is a precondition for conducting effective policy analysis. The Working Group will need to decide on its preferred assessment framework for evaluating options for tax reform.

7. The choice of assessment framework is important for two main reasons. Firstly, the assessment framework will signal the principles and criteria that the Working Group consider most salient to the design of policy. Secondly, the assessment framework will be used to frame and shape all subsequent advice provided to the Working Group.

8. There are many potential approaches to the design of an assessment framework. In order to inform the Working Group's considerations on this issue, this paper begins by introducing two frameworks that are particularly relevant in a New Zealand public policy context:

   - The Treasury's *Living Standards Framework*, which is a general-purpose assessment framework that can be applied to any policy area.

   - An established set of principles that are used in the design of tax policy in New Zealand and many other jurisdictions.

9. Working Group members may also want to raise other considerations or frameworks that will be useful for subsequent analysis.

## 2.2 The Living Standards Framework

*Broad conceptions of wellbeing*

10. Many factors affect New Zealanders' living standards, and many of these factors have value beyond their contribution to material comfort. Aggregate national income, or GDP, is an important enabler of higher living standards – not least because of its direct connection to the tax base – but it is not designed to be a measure of wellbeing.

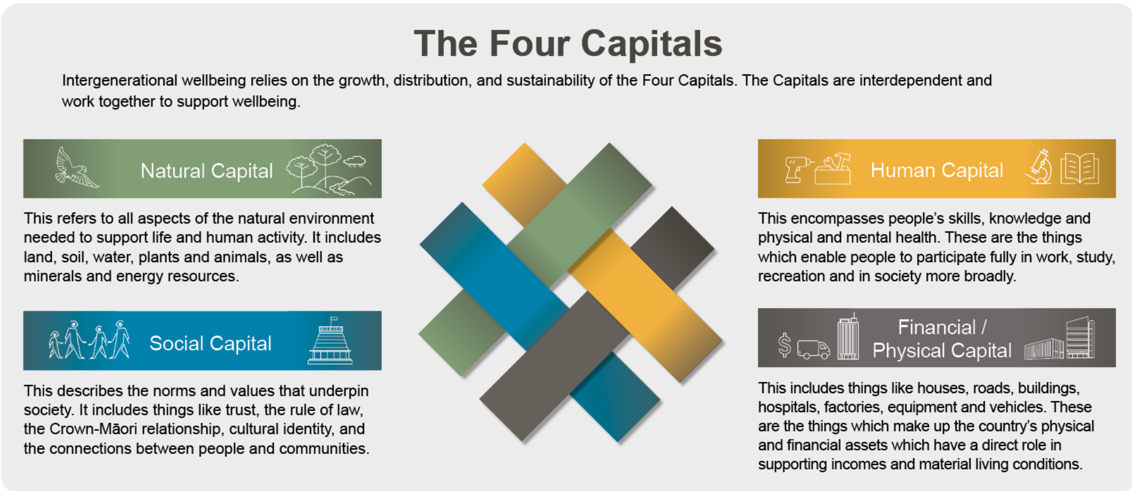
11. To measure wellbeing comprehensively, income measures therefore need to be supplemented with measures of other factors, such as health, connectedness, security, rights and capabilities, inequality, and sustainability.

12. In recognition of the broad basis of wellbeing, the Treasury uses the *Living Standards Framework* to incorporate a more comprehensive range of factors, distributional perspectives, and intergenerational considerations into its analysis.

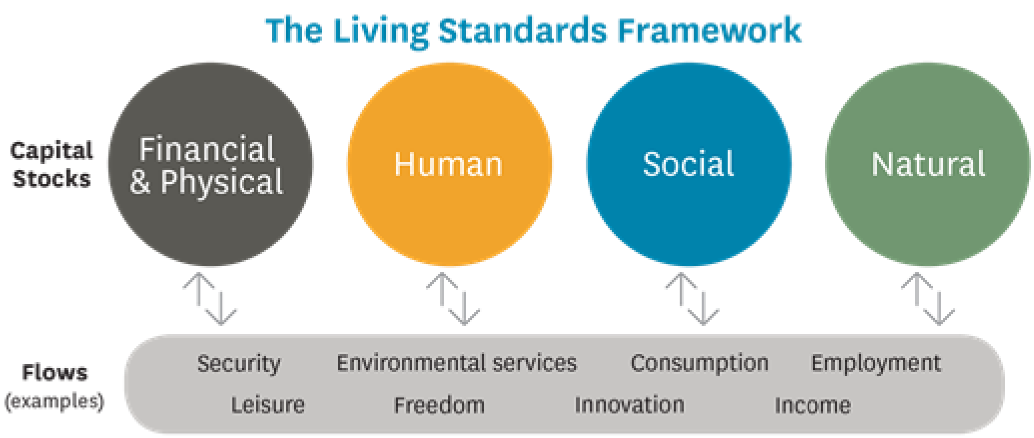
*The 'four capitals'*

13. The Living Standards Framework identifies four capital stocks that are crucial to intergenerational wellbeing: *financial and physical capital*; *human capital*; *social capital*; and *natural capital*.

14. The Treasury represents the 'four capitals' visually as flax strands. When woven together (*raranga*), the strands come together to produce a strong mat (*kete*). Wellbeing is best achieved, metaphorically, when the four capitals are all strong and supporting each other.




15. Firms, households, and the government combine the four capital stocks in various ways to generate flows of tangible and intangible goods and services that enhance wellbeing now and in the future. Intergenerational wellbeing depends on the sustainable growth and distribution of the four capitals, which together represent the comprehensive wealth of New Zealand.



*Applying the Living Standards Framework*

16. The Treasury does not prescribe a specific approach to the application of the Living Standards Framework in policy analysis. Instead, the Framework is intended to be a flexible tool that can help identify dynamics, dependencies, and trade-offs across social, economic, and natural domains.

17. These dynamics are likely to be complex, and our knowledge about them is incomplete. Rather than offering a formal model of wellbeing, the Framework encourages analysts to push analysis beyond the more easily measured (but narrow) financial dimensions, and to identify complementarity, substitutability, interactions and trade-offs between the different types of capitals.

18. One important consideration in applying the Living Standards Framework is that the four capitals do not stand separately: they are interconnected, often in complex ways. Applying the Living Standards Framework therefore tends to result in a more complex and iterative assessment process, but it can also support a broader and richer conversation on the full impacts of change.

### 2.3 The established principles of tax policy design

19. The Living Standards Framework is a general-purpose framework that can be applied to any policy area. It can sit alongside, and complement, the assessment of sector-specific considerations.

20. Such a sector-specific framework already exists within the domain of tax policy, where an established set of principles is commonly applied to the granular assessment of individual policy proposals.

21. Although the exact terms and definitions may vary in usage, these established principles usually cover the concepts of *efficiency and growth*, *equity and fairness*, *revenue integrity*, *fiscal cost/impact*, *compliance and administration cost*, and *coherence.*

22. The Victoria University Tax Working Group, which convened in Wellington in 2009, adopted the following definitions of these principles for its work:

**The Victoria University Tax Working Group's**
**'Principles of a Good Taxation System'**

- **Efficiency and growth:** Taxes should be efficient and minimise as far as possible impediments to economic growth. That is, the tax system should avoid unnecessarily distorting the use of resources (e.g. causing biases toward one form of investment versus another) and imposing heavy costs on individuals and firms. An important question is how various taxes affect key economic and social variables such as employment, investment, savings, productivity growth and international competitiveness.

- **Equity and fairness:** The tax system should be fair. The burden of taxes differs across individuals and businesses depending on which bases and rates are adopted. Assessment of both vertical equity (the relative position of those on different income levels or in different circumstances) and horizontal equity (the consistent treatment of those at similar income levels, or similar circumstances) is important. The timeframe is also important, including how equity compares over peoples' life-times.

- **Revenue integrity:** The tax system should be sustainable over time, minimise opportunities for tax avoidance and arbitrage, and provide a sustainable revenue base for government.

- **Fiscal cost:** Tax reforms need to be affordable given fiscal constraints.

- **Compliance and administration cost:** The tax system should be as simple and low cost as possible for taxpayers to comply with and for the Inland Revenue Department to administer.

- **Coherence:** Individual reform options should make sense in the context of the entire tax system. While a particular measure may seem sensible when viewed in isolation, implementing the proposal may not be desirable given the tax system as a whole.

(Victoria University Tax Working Group, 2010, p. 15).

23. These principles have also been applied in the context of other large 'flagship' reviews of national tax systems:

    - The 'Henry Review' of Australia's tax system, which reported in 2009, applied the design principles of *equity*, *efficiency*, *simplicity*, *sustainability*, *and policy consistency* (Commonwealth of Australia, 2010).

    - The 'McLeod Review' of New Zealand's tax system, which reported in 2001, emphasised the principles of *efficiency* and *fairness* in its recommendations for reform (McLeod et al., 2001).

24. There is also a rich academic literature exploring various aspects of these principles as they apply to the design and implementation of tax systems around the world.

### 2.4 A note on fairness

25. The concept of 'fairness' is central to considerations of tax policy. It is explicitly one of the established principles of tax policy design, and it also contributes to the sense of trust that undergirds social capital. At the same time, 'fairness' is a notoriously difficult concept to define and agree upon.

26. In recognition of the importance of fairness, we have prepared a separate paper that outlines several approaches for defining fairness, since the Working Group's views on what constitutes fairness will need to be reflected in the design of the assessment framework.

# 3. Issues for discussion

27. This first discussion is an opportunity for the Working Group to explore the merits of various assessment frameworks, before coming to a final decision at the meeting on Friday 23 February.

28. In the Secretariat's view, the two frameworks are complementary. One possible approach could therefore be to conduct a *dual assessment* of proposals against both frameworks, to ensure a full range of impacts are captured and considered by the Working Group.

29. As a way of working towards a final decision at the February 23 meeting, we suggest that the Working Group consider the following questions during this first discussion:

- Do you have any questions about the application of either framework?
- What are the merits and drawbacks of each framework?
- What considerations are common to them both? What considerations are not covered adequately?
- Are there any other considerations that are not dealt with appropriately by either framework?
- What alternative frameworks could be used to address these considerations?

# References

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McLeod, Robert, et al. (2001). *Tax Review 2001: Final Report*. Retrieved from http://www.treasury.govt.nz/publications/reviews-consultation/taxreview2001/taxreview2001-report.pdf

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