



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.

Tax and fairness

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

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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

TABLE OF CONTENTS

Executive Summary	3
1. Introduction	4
<i>1.1 Purpose</i>	4
2. Principles of fairness and considerations	5
<i>Why do we care about fairness?</i>	5
<i>Vertical equity and progressivity</i>	5
<i>Horizontal equity</i>	15
<i>Other considerations</i>	17
3. Questions for Group	19
Appendix 1: Data and modelling	21
References	22

Executive Summary

The terms of reference of the Tax Working Group include consideration of whether the tax system operates fairly in relation to taxpayers, income, assets and wealth.

What is fair relies on value judgements and there is not likely to be universal agreement.

Standard frameworks for considering fairness focus on two main principles:

- **Vertical equity:** The principle that those with higher income, or higher ability to pay, should pay a greater amount of tax.
- **Horizontal equity:** The principle that people that are in the same position should pay the same amount of tax.

Within these principles remain a number of additional value judgements. For example, within vertical equity there is a question about what level of progressivity is considered fair, and how to measure a person or household's ability to pay. Fairness may also be considered within and between certain groups including generations, genders, and other social and demographic groups.

Although fairness matters inherently, fairness can also be related to other aspects of wellbeing. In the Treasury's Living Standards Framework, fairness is related to social capital through its impact on trust and social cohesion and human and physical capital by supporting people to participate in society.

In assessing the fairness of taxes, a number of additional complexities arise. For example, assessing who bears the economic incidence of tax, how to identify who the relevant 'person' is; when there are entities such as companies or trusts involved, and how fairness should be considered where taxes may be paid in other jurisdictions. There are also issues in the fairness of changes in tax rules, which can create windfall gains and losses.

Outside of the standard principles there may be a number of additional areas the Group considers important for fairness. For example, there is the question of how to achieve fairness and the extent to which fairness should be achieved through tax alone or also through government transfers or spending.

This paper aims to prompt discussion on what the Group thinks fairness means in a tax system. It is intended to enable the Group to come to a view on where there is agreement amongst members on fairness, where there is not, and to understand areas of disagreement between members. It also aims to identify what information members think that officials should be endeavouring to provide to help the Group assess fairness issues. The role of the Secretariat will be to provide the evidence base that can support Members to make judgements about the fairness of tax settings.

1. Introduction

1.1 Purpose

1. The terms of reference of the Tax Working Group include consideration of whether the tax system operates fairly in relation to taxpayers, income, assets and wealth.
2. What is fair relies on value judgements and there is not likely to be universal agreement. This note is intended to discuss aspects of fairness to prompt discussion on what the Group thinks fairness means in a tax system. It is intended to enable the Group to find where there is agreement between members on fairness issues and where there is not and to understand areas of disagreement between members.
3. In addition, a better understanding of what the Group is concerned about when looking at fairness will help officials provide evidence and advice to the Group that is focused on what the Group considers important.

2. Principles of fairness and considerations

Why do we care about fairness?

4. At its core fairness matters because people want tax to be fair. In and of itself, fairness is something that people want and want the tax system to follow. Some may view that tax fairness is based on a principle of duty or obligation on every person to pay what they ought to pay. Alternatively people may view that tax fairness is about everyone meeting their social obligation to pay their fair share.
5. Fairness also has other benefits. It encourages voluntary compliance as well as trust in public institutions. In the Treasury's Living Standards Framework, fairness is related to social capital through its impact on trust and social cohesion and human and physical capital by supporting people to participate in society.

Principles

6. What is fair ultimately rests on value judgements. There is unlikely to be universal agreement.
7. However, there are generally two main principles that are used to help guide what is fair within in tax policy. These are:
 - **Vertical equity:** The principle that those with higher income, or higher ability to pay, should pay a greater amount of tax.
 - **Horizontal equity:** The principle that people that are in the same position should pay the same amount of tax.

Vertical equity and progressivity

8. An income tax is said to be progressive if those on higher incomes pay a greater proportion of their incomes in tax. It is proportional if everyone pays the same proportion of their incomes in tax (as would happen if there were a flat tax rate, of say, 20%). It is regressive if those on higher incomes pay a lower proportion of their incomes in tax.
9. Most people in New Zealand likely agree with the idea of progressivity and believe that this promotes vertical equity. However, what level of progressivity is right or fair has greater disagreement. For example in the 2016 New Zealand Social Survey over 50% of respondents thought taxes on the rich were too low and half thought they were about right or too high¹ (Grimwood, 2017).
10. As a result, it does not necessarily follow that more progressivity in the tax system necessarily increases vertical equity. Instead it is a value judgement about what degree of progressivity is considered fair. For example:

¹ Surveys that ask questions about the current tax system should be taken with some caution as people have mixed knowledge about tax.

- Would a 90% marginal tax rate on all income above a certain threshold to pay for income tax cuts for poorer households be considered fair? If so, what about a 99% tax rate or a 100% marginal tax rate?
- Do we want someone who is required to work long hours or undertake an arduous or risky occupation to earn the same income as a person who chooses not to work?

Progressivity in context of transfers and expenditure

11. Vertical equity can be considered more widely than progressivity of taxes. The Government achieves distributional goals through transfers (i.e. cash payments to households such as Working for Families tax credits or welfare benefits) and other government expenditure as well as through a progressive tax system.
12. For example a country could theoretically have a proportional or even regressive tax system, but if the revenue is used for progressive purposes then the overall system can distribute significant amounts to lower income households.

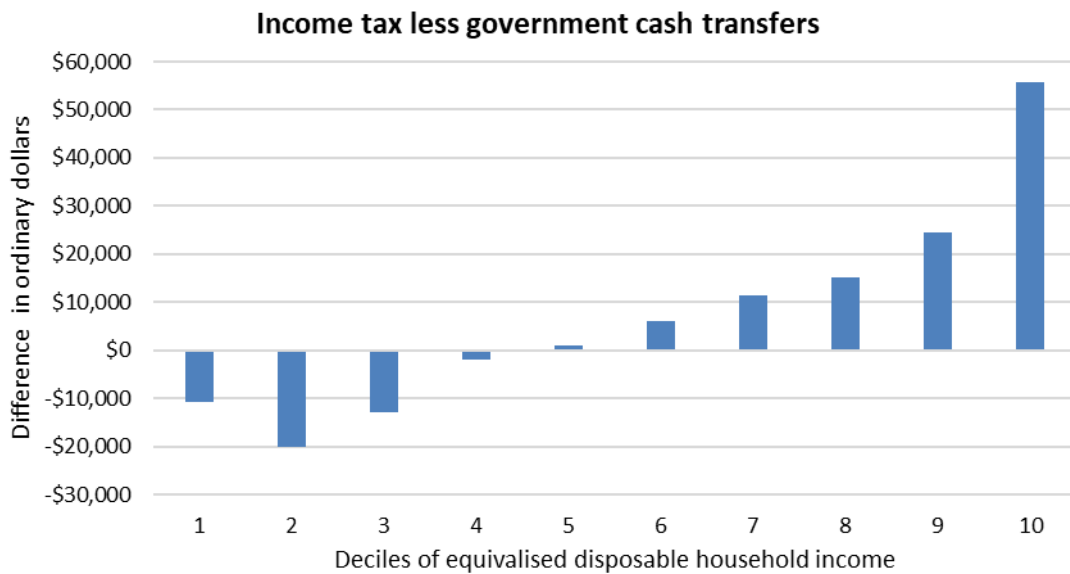
Example

Take a theoretical country with two types of households. Rich households that earn \$100,000 and poor households that earn \$20,000.

If the country introduced a flat tax of 10% then the tax system would be considered proportional.

However, if the government used the revenue from this tax to transfer \$12,000 to poorer households it would result in a very 'progressive' overall system.

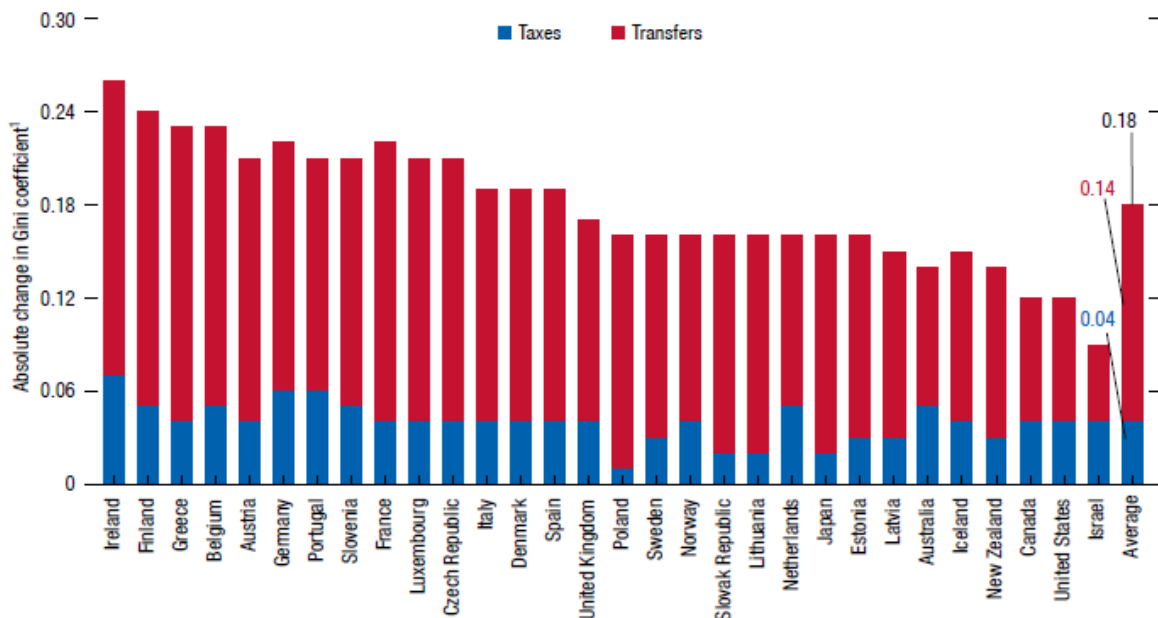
13. Looking at tax and transfers by income deciles in New Zealand shows that the bottom four income deciles pay less in income tax than they receive in transfers.



Bryan Perry, Ministry of Social Development, 2017
Data based on Household Economic Survey 2015

14. The bulk of redistribution in New Zealand occurs through transfers and this is consistent with most other countries. The lower level of redistribution in New Zealand compared to the OECD average appears to be in part due to lower average level of transfer payments made in New Zealand (compared to the more generous welfare systems in Europe). This is despite New Zealand's high level of targeting of transfers.

Redistributive impact of taxes and transfers in advanced economies, 2015 or latest year



Source: Organisation for Economic Co-operation and Development, Income Distribution Database.
¹Calculated as Gini coefficient for market income minus Gini coefficient for disposable income.

15. In addition to welfare transfers, progressivity can be looked at taking into account government expenditure.

Example

Take the same example as above. However, instead of welfare transfers the government uses the revenue on government spending that equally benefits both types of households.

In this case, the poor household would spend \$2,000 of taxes and receive \$6,000 in benefits. This could be considered a ‘progressive’ overall system despite a proportional tax system.

16. In New Zealand the most recent research estimates that in 2010 more than half of health and education expenditure was spent on decile 1-5 households. As a result, an important consideration when considering vertical equity is whether it should be achieved through tax or through spending.

Figure 7: Average cost of health services received by a household in each decile (\$2010)

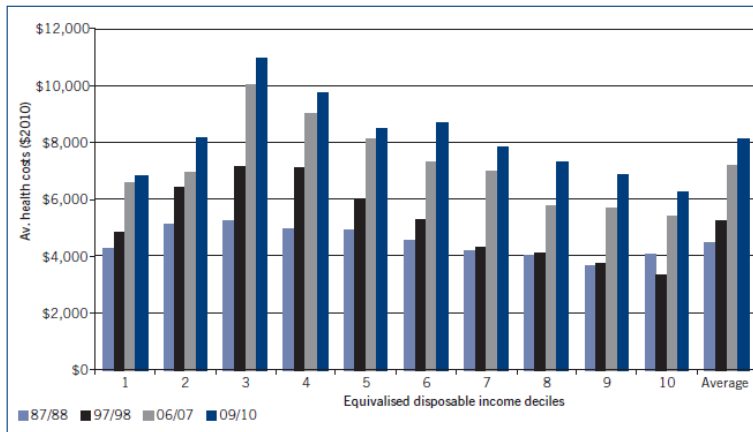
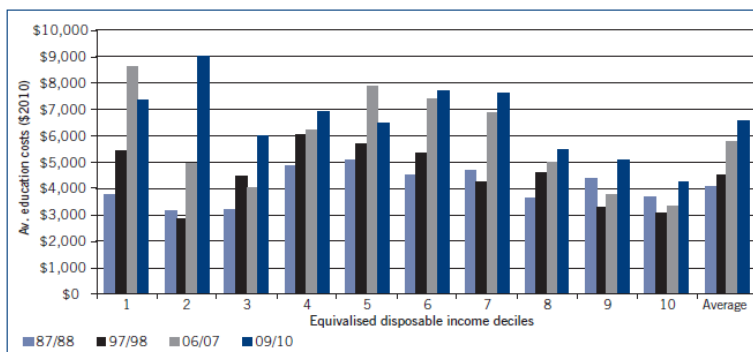


Figure 8: Average cost of education services received by a household in each income decile (\$2010)



17. The table below shows how measured Gini inequality² reduces once government expenditure is taken into account.

Gini coefficient for different measures of household income

	1988	1998	2007	2010
Market income	0.42	0.49	0.54	0.52
Disposable income	0.30	0.35	0.38	0.36
Final income (disposable income plus costs and benefits from GST and government expenditure)	0.27	0.30	0.35	0.33

How you measure progressivity and inequality is important

18. There are a number of ways to measure progressivity and vertical equity. Which measure is used is important as it reflects a judgement about what concern is trying to be addressed through progressivity and vertical equity. For example, the impact of tax can be measured against:

- current income;
- income after housing costs;
- expenditure;
- the tax impact on poverty; and
- wealth.

Current income

19. Income is often used as the main benchmark to measure progressivity. Current income reflects a person or household's immediate consumption capability. Taxes and transfers have a significant impact on the level of income inequality in New Zealand. The amount of reduction in inequality is less than the OECD average.

² The 'Gini' coefficient is a method of measuring income inequality by comparing the share of total income in a country held by each person in that country. A score of 1 represents maximum inequality where one person has all the income and a score of 0 represents full equality where everyone has the same income. It is important to note that the Gini coefficient is only one way of measuring inequality, albeit a very common one.

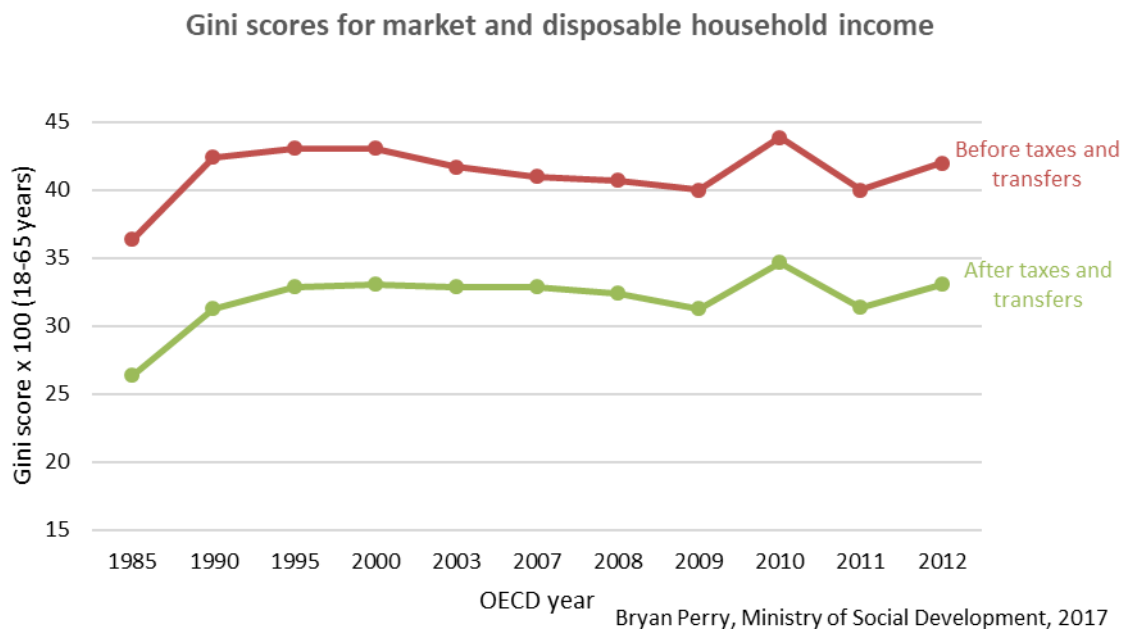
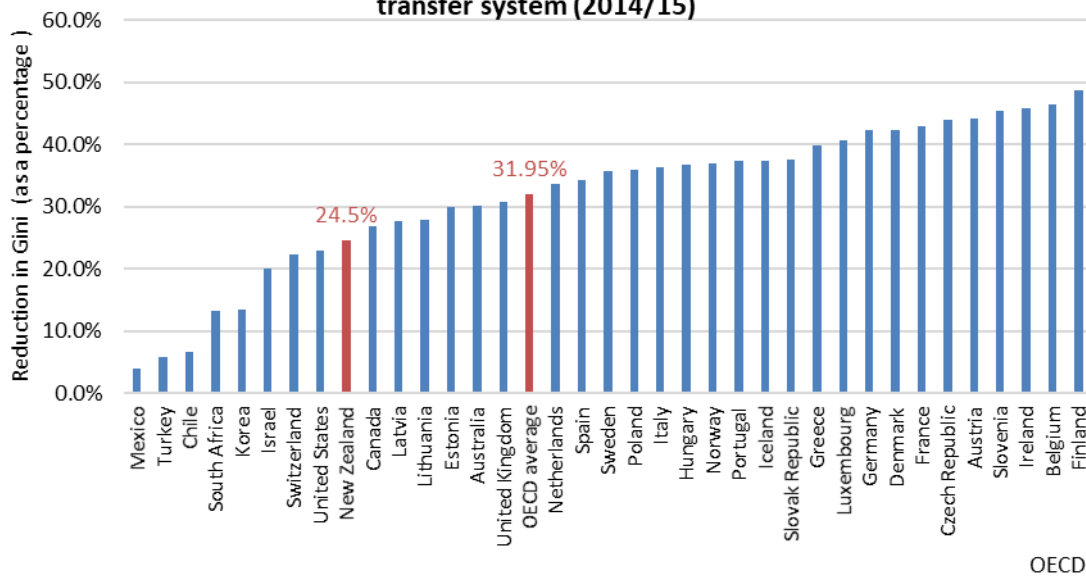
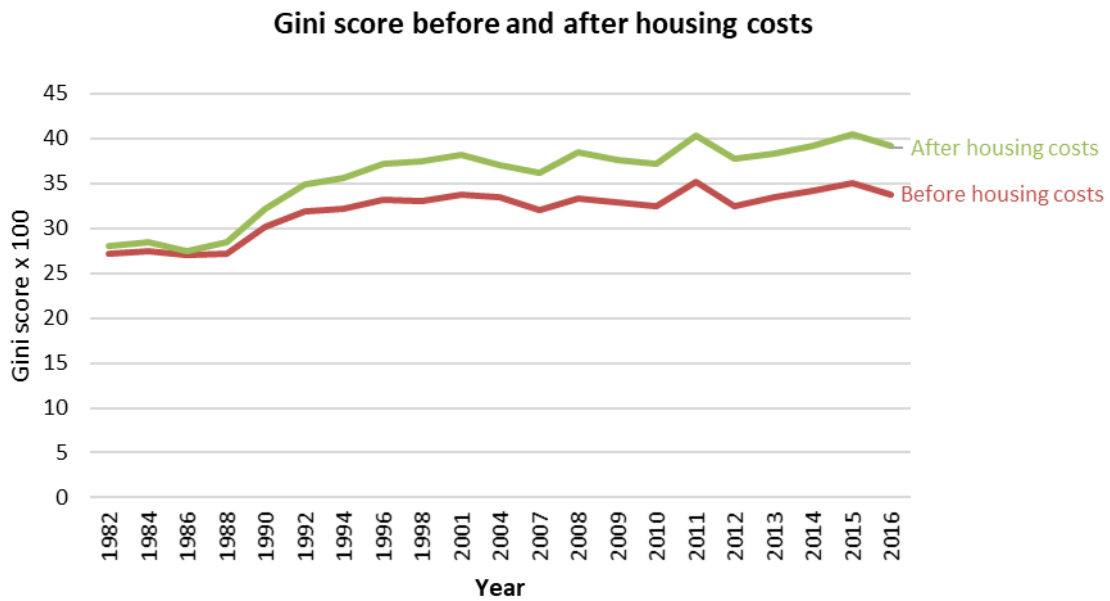


Figure 16: Reduction in the Gini coefficient on account of the tax and transfer system (2014/15)



Income after housing costs

20. Instead of solely using just current income, progressivity might also be considered to be better measured against a person’s ability to achieve a basic standard of living. If so, a person might want to consider households’ income after essential costs, such as housing. Including housing costs increases the degree of inequality.



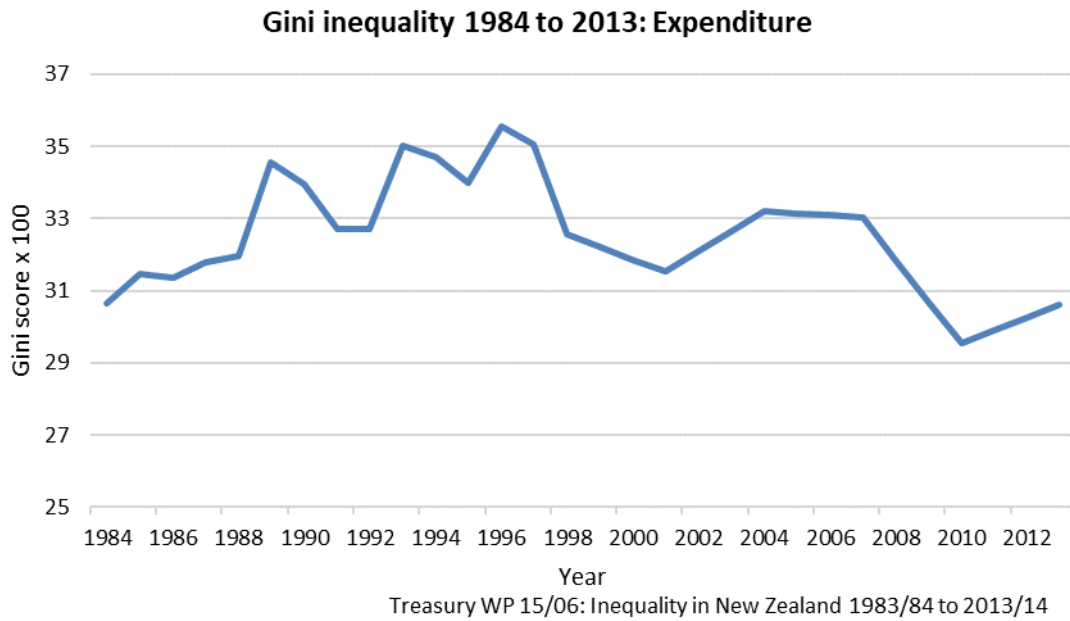
Bryan Perry, Ministry of Social Development, 2017

Lifetime income and expenditure

21. Current income is limited as it does not consider lifetime incomes. A person's income will generally change over their lifetime. A tax burden which might seem high compared with their current income may not be when viewed over their lifetime income. However, we do not have measures of lifetime incomes in New Zealand and as a result cannot estimate the impact of taxes over the lifecycle.

22. One other measure that is used is expenditure. Expenditure tends to be smoother over a person's lifetime than income and some would argue that it provides a better proxy than current income for a household's lifetime income. Research in New Zealand also indicates that expenditure provides a better proxy for overall wellbeing than current income (Carver & Grimes, 2016). Looking at expenditure indicates lower inequality than income based measures³.

³ The Secretariat is working on sourcing tax paid by consumption deciles.



23. A study for the UK’s Institute of Fiscal Studies found that much of the UK’s tax and benefit system redistributes across periods of life and as a result does not have as much effect on lifetime inequality compared with current inequality (Levell, Roantree, & Shaw, 2016). It is possible that similar results would apply in New Zealand, in particular given that net spending by age groups tends to be focused towards the young and old.



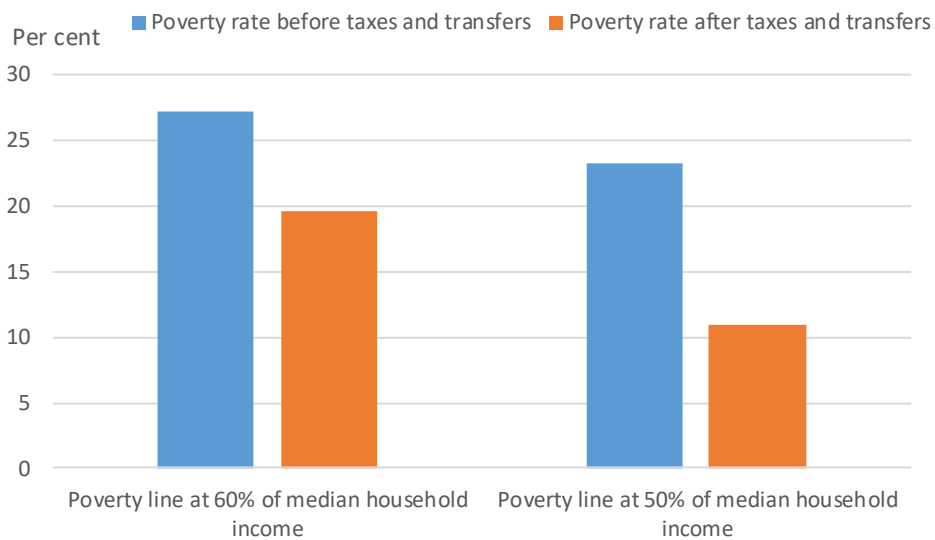
(Aziz, Gemmell, & Laws, 2013)

⁴ Note: includes impact of all taxes and public spending that can be attributed to age groups (ie, analysis is not restricted to income taxes and transfers).

Poverty

24. Measuring the impact of taxes on poverty alleviation may also be considered important. Defining poverty and the determination of the poverty line involves a value judgement. In particular there is a judgement about whether relative poverty (measurement of household wellbeing against the average wellbeing) or absolute poverty (a minimum set of standards) is considered most relevant. Taxes and transfers play an important role in reducing poverty in New Zealand.

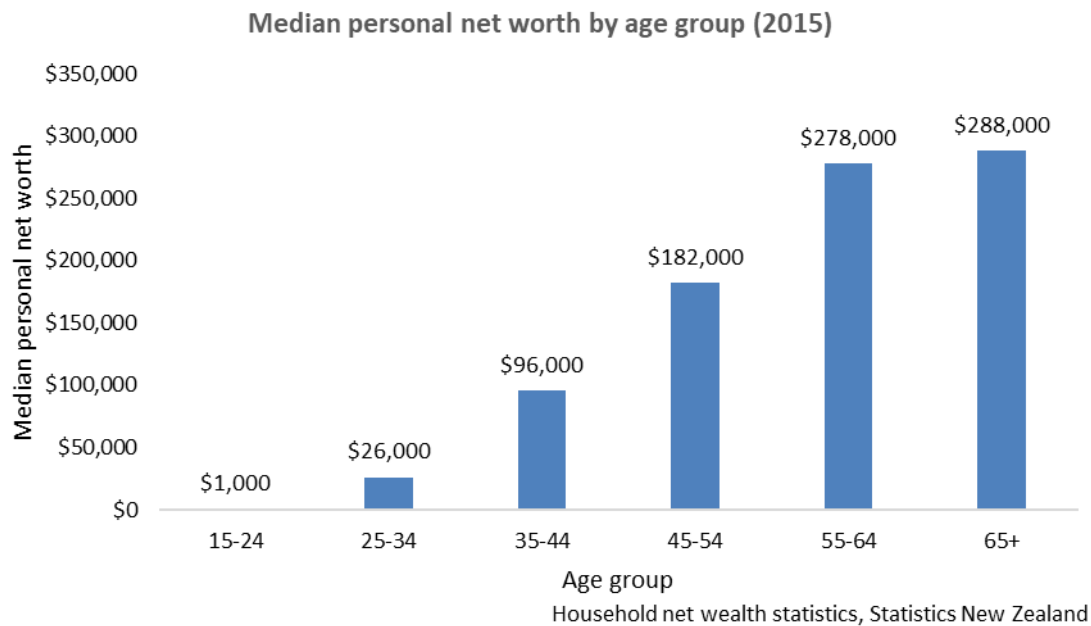
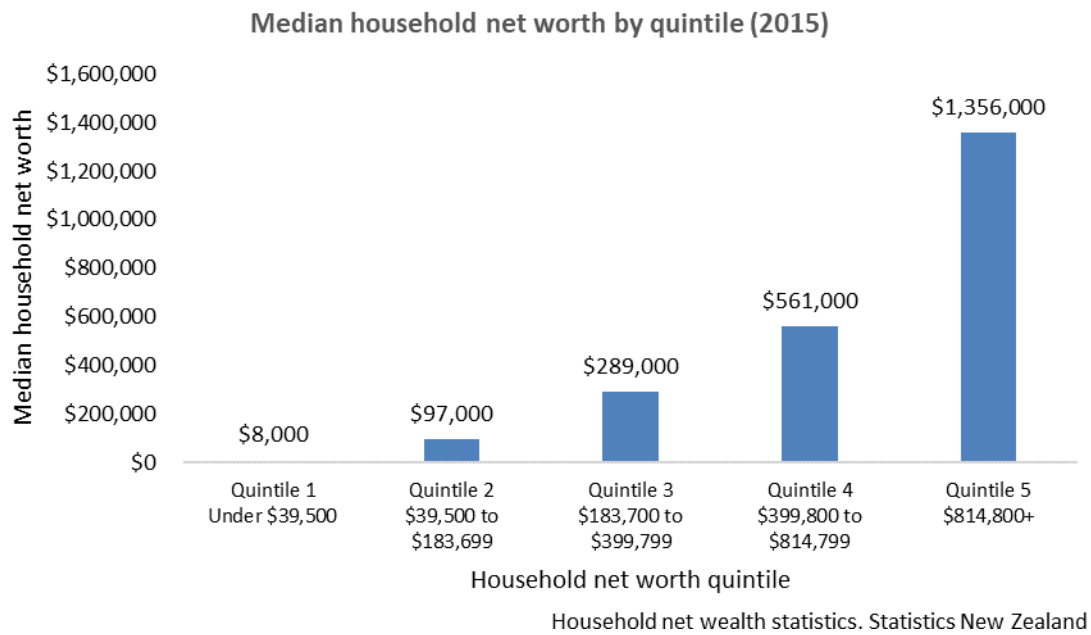
Household poverty rates in New Zealand



Source: OECD

Wealth

25. There has been concern about wealth inequality and debate about the degree to which tax should address wealth inequality. Whether wealth inequality is fair is a value judgement. Judgements here may depend on how wealth inequality has come about. Some wealth inequality may be solely attributable to people saving through their lifetime. This is shown in the below figure which shows median net worth for different age groups. Some wealth inequality may come about because some choose to save more than others.



26. However, other wealth inequality may come about because of differences in talents or inheritances or inherent inequalities of opportunity. How should we think about the fairness or otherwise of wealth inequalities? Moreover, if we are concerned about wealth inequalities are these best addressed through a broad-based comprehensive progressive income tax or a tax on wealth?
27. One key question for the group is on which measure they think should be used when considering progressivity and inequality. The Group's consideration of this will also help enable officials to focus future analysis on these areas.

Horizontal equity

28. Horizontal equity is the idea that people in the same position should pay the same amount of tax. There tends to be less disagreement with the concept of horizontal equity as most agree that like should be treated with like.
29. One way of viewing horizontal equity in New Zealand's tax system is that people earning the same amount of income should pay the same amount of income tax and people with the same amount of consumption pay the same amount of GST. Similar considerations could apply for other taxes such as excises and to consider whether like is being considered with like.
30. Horizontal equity and vertical equity are also linked. For example if a specific departure from horizontal equity benefits relatively higher or lower income households then it can impact vertical equity. For example the non-taxation of capital gains means that some income is treated differently from others which will have a horizontal equity impact. To the extent that those who earn capital gains tend to be on higher incomes, it will also have a vertical equity impact.

Economic incidence

31. When looking at the impact of taxes the economic incidence of the tax matters. Economic incidence is the concept that although one person may have to legally pay a tax, another person can often incur the true cost of the tax.
32. One example of this is GST. GST is legally paid for by the businesses who supply goods and services. However at least part (and probably a large part) of the true cost of GST will be passed on to consumers through higher prices. In incidence studies it is often assumed that consumers bear the full burden of taxes on consumption. Another example is considered below for interest paid to non-residents.

Economic incidence and non-resident lenders

Currently the 'Approved Issuer Levy' rules impose a 2% tax on interest paid to non-residents (that are genuine third party lenders and not associated with the borrower).

The economic incidence of this tax is generally considered not to be on the non-resident lender. Foreign investors are likely to demand that NZ borrowers pay interest to them that matches the worldwide rate of return.

If, for example the pre-tax world interest rate is 5%. If New Zealand imposes a 2% tax on interest paid to non-residents, then the non-resident lender will demand a 5.1% return on their investment, otherwise they can go elsewhere to get a better return.

This results in the 2% tax being fully borne by the New Zealand borrower. So when asking about the fairness of these rules the key question is what level of tax should be borne by the New Zealand borrower (through higher borrowing costs).

Changes in tax rules and effects on past decisions and investments

33. Tax changes, even when legally prospective, can be considered to have an economically retroactive effect. This can occur when a tax change affects a person because of a previous decision or investment. These decisions or investments may have been made on the expectation of the continuation of the status quo for tax rules and changing tax rules can also create uncertainty which can make people risk averse to decisions and investments in the future.
34. Probably all major tax changes will affect the outcomes from decisions people have made earlier in their lives. This can result in windfall gains and losses for particular people. For example, changing tax rates can affect the benefits of the study and training that people have undertaken, or changing tax rules for housing can have costs for those that have invested in housing in the past. Obviously saying that there should be no retroactivity would be tantamount to saying that there should be no tax reform.
35. Sometime, however, tax changes are made which ‘grandparent’ certain arrangements that have been made in the past. A question when considering tax reform is whether the transition to any new regime is fair.

Who do you look at when considering horizontal equity?

36. In our tax system there are differences in the tax rules depending on the type of entity a person transacts through. For example there are separate income tax rates for companies, trusts, Māori Authorities and individuals.
37. These differing rules raise horizontal equity issues. People with the same amount of income can be taxed differently depending on what entity they operate through. There is also the question about whether for these entities the tax burden should be looked at by looking through the entity to the underlying economic owners of the entity (for example the shareholders of the company).
38. Part of the Terms of Reference for the Working Group is to consider whether a progressive company tax (with a lower rate for small companies) would improve the tax system and business environment. Whether a company should be looked through to its economic owners for taxation purposes is an important consideration for evaluating this.

Other considerations

User charges

39. In some areas, the principle of ‘user pays’ is also considered relevant. This is the idea that those who receive the benefit from a government service should pay for it. Some examples of user charges in New Zealand include passport or DOC fees and fuel taxes that are levied based on the principle that road users should pay for roads and other services that benefit road users.
40. However, the use of user pays as a principle for taxation in New Zealand is limited and the majority of Government revenue is raised through income tax and GST. However, sometimes as with Road User Charges, there is an element of user pays. Whether it is fair for a particular piece of expenditure to be funded from those who benefit from the expenditure is a value judgement. Different areas of spending may be considered more fairly paid by wider society than through the individuals consuming the services. A question is whether there should be a greater use of user charges?

Demographic impact

41. Certain equity issues could be considered in the context of specific demographic groups that are more heavily impacted by them. For example, what specific impact taxes have on women, Māori or other ethnicities, or intergenerational fairness may be an area of concern for the Group.
42. Intergenerational fairness concerns may arise because the structure of taxes and government spending give rise to intergenerational transfers of resources. New Zealand is sometimes said to have an “intergenerational contract” which assumes that people pay most taxes during their working lives and less at the beginning and end of life (when they are more likely to receive services and payments funded by taxpayers).
43. Taxes may also create unintended transfers between generations, particularly if tax settings influence the value of assets (for example land prices). Demographic change, particularly an ageing population, will also affect these transfers between generations. How the tax system influences natural resource use may also have long-term effects with different impacts on future generations. Intergenerational fairness is a difficult concept to define or measure precisely, but understanding the effects that tax settings have on different age groups can assist in forming judgements.
44. Issues of gender fairness arise as the design of the tax system may impact both the distribution of income between women and men as well as the distribution of paid and unpaid work.

Administration

45. How a tax system is administered and operates in practice is important for considering fairness. Those who evade or avoid paying taxes undermine fairness in the tax system. A consideration for the Group may be whether the degree of evasion or avoidance in our tax system is undermining fairness and whether there is appropriate enforcement of taxes.

Potential areas of concern with our system

46. There are a number of areas where the Group may consider there are fairness concerns in our tax system. These could include:
- ***Whether our broad-base low rate approach to taxation is right?:*** Should our tax framework be revised or revisited?
 - ***Rates and thresholds:*** Whether our tax rates and thresholds achieve enough progressivity? (noting that the Terms of Reference provide that increasing any income tax rate or the rate of GST are outside the scope of the Group's review)
 - ***Gaps in our tax base:*** For example the non-taxation of income from capital gains.
 - ***The degree of complexity in our tax system:*** There is evidence that tax complexity benefits those on higher incomes who are able to utilise the complexities to achieve a better tax result.
 - ***Enforcement:*** Is there appropriate enforcement to ensure everyone pays their fair share of tax?
 - ***Are there taxes that we should have but don't?:*** For example should New Zealand tax wealth or apply a land tax?
 - ***Inter-generational:*** Is it fair for future generations to pay for the health and pensions of previous generations? Do tax settings impact housing affordability for younger generations?

Methods to achieve fairness and efficiency considerations

47. One key question is if the Group want to achieve further distributional goals is what the best method is to achieve this. Distributional goals can be achieved either through the design of the tax system, or through the use of tax revenue in a progressive manner.
48. Generally within tax there are considered to be methods which are relatively better than others at achieving progressivity. It will be important to ensure that whatever level of progressivity is wanted in a tax system is achieved as efficiently as possible.
49. In addition more widely sometimes fairness considerations may need to be traded off against other goals of the tax system. For example currently our fringe benefit tax rules are not comprehensive and this is done in part because of the compliance costs of trying to identify and value private benefits received by employees. How much to trade-off efficiency and other considerations against fairness is another value judgement.

3. Questions for Group

50. In order to help us assist the Group in its consideration of the fairness of the New Zealand tax system, we have identified a number of questions below on which the Group may wish to provide us with guidance.
51. A fundamental question for the Group is whether they think that our broad-base low-rate tax framework on income and consumption remains broadly appropriate? Alternatively is there a fundamental concern with the fairness of New Zealand's approach to taxation and should a different tax framework be explored?

Principles

- Does the Group agree that the concepts of horizontal and vertical equity provide an appropriate basis to discuss fairness?
- Are these concepts broad enough to include the views of all communities in New Zealand, including Māori, or are there other issues that should also be raised?
- To what extent is the Group concerned with fairness issues that may fall outside of these principles? For example, could a tax provision that may be considered unfair when viewed in isolation, be beneficial for wider social goals?
- Taxes generally affect market prices and it is difficult to determine the incidence of a tax. Does the Group want indications of incidence impacts where possible?

Vertical equity

- Does the Group agree that vertical equity should be examined in the context of the overall system of tax and transfers?
- Should all taxes be taken into account e.g. income, GST, excise taxes and/or rates?
- When looking at progressivity, what does the Group want to measure the level of taxes against?
 - Current income?
 - Expenditure? (as a proxy for wellbeing and lifetime income?)
 - Impact on poverty?
 - Wealth?
- Are there any particular areas of concern about vertical fairness on which the Group wishes more research to be conducted?

Horizontal equity

- Are there fairness concerns around gaps within current tax bases and the implications on the distribution of tax?
- Should tax burdens on entities and trusts be looked at by looking at the underlying economic owners of the entity?

Other considerations

- Is the Group concerned about the impact of taxes on specific demographics?
- Is intergenerational equity an area of interest for the Group?

- When should taxpayers pay for the benefits they receive from Government? Are there certain services that should be addressed by user pays? Are there taxes that are better considered to be user pays and left out of fairness measures?

Appendix 1: Data and modelling

52. The Secretariat's role is to provide Members with analysis to inform its judgments about fairness. The main source for distributional analysis of wealth and income is Statistics New Zealand's Household Economic Survey (HES), which records incomes and family circumstances for a representative sample of New Zealand households.
53. The Treasury maintains a microsimulation model of the New Zealand personal tax and transfer system using HES data. Microsimulation refers to a modelling technique that applies policy changes to individuals in the input data, and then aggregates the results so that they are representative of the New Zealand population. Modelling of distribution has tended to focus on income measures of inequality and income adequacy. This includes statistics such as the Gini coefficient of income inequality, ratios of top and bottom incomes and poverty rates (before housing costs).
54. There are a number of limitations to analysis of household incomes. In particular, it focusses on distribution at a point in time rather than over the lifecycle, measures income rather than wealth, and uses measures of taxable income that exclude some sources of economic income (such as untaxed capital gains).
55. To address the need to provide distributional analysis of wealth and capital income, the Secretariat will undertake analysis of the distribution of household assets, liabilities and wealth from the 2014/15 HES. However, this will be new analysis and there will be limited ability to draw inferences owing to a range of limitations: there is only one year of comparable wealth data and small samples sizes will limit the ability to undertake highly detailed analysis.

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