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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 Working Group Assessment Framework

Decision Paper for Session 3
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

TABLE OF CONTENTS

1. Introduction 3

2. The overall approach 4

2.1 Key takeaways from the initial discussion 4
2.2 The proposed approach 4

3. Proposed definitions for the established principles 5

4. Applying the Living Standards Framework to tax policy 6

4.1 A 'four capitals' assessment 6
4.2 Interactions between tax policy and the four capitals 6
4.3 Interconnections between the four capitals 8

5. Conclusion 9

Appendix: Assessment Templates 10

References 14

1. Introduction

1. This paper seeks a decision on the Tax Working Group's preferred assessment framework for evaluating tax reform.

2. The Group had an initial discussion on various approaches and frameworks for assessing tax reform at the meeting on Friday 9 February. The assessment framework proposed in this paper reflects our understanding of the outcomes of that initial discussion.

3. The paper has three main parts.

   - Section 2 sets out the overall approach for the proposed assessment framework, which combines the Living Standards Framework and the established principles of tax policy design.

   - Sections 3 and 4 provide further detail on the application of the proposed framework.

4. The Appendix provides a set of templates that the Secretariat is planning to use to structure the analysis of individual proposals. The Secretariat can adjust these templates as necessary to reflect the needs of the Group.

5. The Group is asked to decide whether it would be comfortable using the approach set out in Section 2.

2. The overall approach

2.1 Key takeaways from the initial discussion

6. The Group's initial discussion on Friday 9 February explored the merits and drawbacks of both the Treasury's Living Standards Framework and the established principles of tax policy design.

7. The Secretariat took away three main messages from this initial discussion:

    - The Group considers that the Living Standards Framework and the established principles of tax policy design both offer valid and useful perspectives on the issues before us.

    - The Group sees a great deal of complementarity between the established principles and the Living Standards Framework. The Living Standards Framework provides a lens to think about the performance of the tax system as a whole, whereas the established principles are useful in assessing the merits of individual proposals.

    - The Group would like to apply both the established principles and the Living Standards Framework to the work ahead.

2.2 The proposed approach

8. In light of this discussion, the Secretariat proposes the following approach to the assessment framework:

    - The Group can use the Living Standards Framework 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 will be assessed against the established principles of *efficiency and growth*, *equity and fairness*, *revenue integrity*, *fiscal cost*, *compliance and administration cost*, and *coherence*.

    - The Secretariat will also apply a Living Standards lens 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.

9. The following sections set out proposed definitions for the established principles, as well as some relevant considerations when applying the Living Standards Framework to the domain of tax policy.

3. Proposed definitions for the established principles

10. In order to maintain consistency with current and past practice in New Zealand, the Secretariat proposes to adopt the definitions of the principles used by the Victoria University Tax Working Group in 2009.

11. These principles are defined as follows:

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).

4. Applying the Living Standards Framework to tax policy

4.1 A 'four capitals' assessment

12. The Living Standards Framework will be used to help frame assessments of the performance of the tax system as a whole. The Secretariat will also apply a Living Standards lens 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. This will allow the Group to form a view on the *financial and physical capital, human capital, social capital* and *natural capital* impacts of the tax system as a whole, and, where useful, individual proposals.

13. This section outlines some of the perspectives that will be important in conducting a 'four capitals' assessment in the domain of tax policy. In some cases, these perspectives are already captured by the established principles of tax policy design. In other cases – notably social capital and natural capital – the Living Standards Framework will introduce a broader range of considerations into analysis.

14. This set of issues is not intended to be exhaustive, and other issues of interest may arise in the course of analysis.

4.2 Interactions between tax policy and the four capitals

Social capital

15. Social capital refers to the norms and values that underpin society. It includes things like trust, the rule of law, the Crown-Māori relationship, cultural identity, and the connections between people and communities.

16. The tax system affects, and is affected by, levels of social capital. This is because the tax system relies on an implicit social contract between citizens and the Government: in a democracy such as ours, the Government's ability to tax ultimately depends on the consent and acceptance of its citizens.

17. A poorly-designed and poorly-administered tax system will undermine public trust and confidence in the Government. There are three broad risks to trust and confidence:

    - **Fairness.** A system that distributes the costs of taxation in a way that is perceived to be unfair will generate resentment, and thereby undermine social capital. Perceptions of unfairness will also erode public acceptance of the prevailing levels of taxation, as well as the spirit of voluntary compliance by taxpayers that underpins efficient tax collection.

    - **Compliance and administration.** A complex, poorly-administered tax system will undermine voluntary compliance and reduce confidence in the competence of the Government. (Increasing the cost to taxpayers to comply with the tax system may also reduce their ability to accumulate physical and financial capital.)

- **Sustainability.** A tax system perceived to be unsustainable over time will reduce public confidence in the Government's ability to deliver on its future obligations to its citizens.

18. Within a New Zealand public policy context, a social capital assessment should also identify and assess any specific impacts on Māori interests through the tax system.

19. A social capital assessment will therefore involve a qualitative assessment of any impacts on *public trust and confidence* and on *Māori interests* (including any wider implications for the Crown-Māori relationship).

Human capital

20. Human capital refers to people's skills, knowledge, and physical and mental health – the things that enable people to participate in work, study, recreation, and in society more broadly.

21. The tax system can impact human capital formation by influencing choices about when and how to increase skill levels. Formal training and education are not the only means to boost human capital: much learning occurs on the job, so labour force participation is also relevant to considerations of human capital.

22. Labour force participation also impacts on social capital, but the effects are ambiguous: although the workplace is central to social connections for many people, working longer hours to achieve the same after-tax income may erode social and family connections in some cases.

23. Forming a judgement about the human capital impacts of tax policy will involve an assessment of impacts on *incentives to work* and *incentives to increase skills*. The Secretariat recognises that human capital encompasses a broader range of considerations than skills and knowledge, and could note those considerations where feasible to do so.

Financial and physical capital

24. Financial and physical capital refers to the financial and physical assets that have a direct role in supporting incomes and material living conditions. Physical assets include things like houses, roads and buildings; financial assets include things like cash, shares, and bonds.

25. The tax system impacts stocks of financial and physical capital by influencing decisions – by both firms and individuals – about when, and how much, to save and invest. A standard efficiency goal for the tax system would therefore be to minimise impediments and distortions that affect the accumulation of financial and physical capital (and, more broadly, economic growth).

26. Forming a judgement about the financial and physical capital impacts will involve an assessment of the way tax affects *incentives to save* and *incentives to invest*, including the extent to which those changes distort saving and investment patterns. Another consideration will be the impact of tax policy on risk-taking and entrepreneurial activity. In practice, there is likely to be significant overlap between a traditional 'efficiency' assessment and a financial and physical capital assessment.

Natural capital

27. Natural capital refers to all aspects of the natural environment that are needed to support life and human activity. It includes land, soil, water, plants and animals, as well as minerals and energy resources.

28. The economy, and human society more broadly, do not exist independently from natural capital: stocks of natural capital provide the environmental services and life-support mechanisms that enable growth and development.

29. The tax system affects incentives for the use of the natural resources that make up natural capital. Taxation can be used in order to achieve efficiency goals, such as fostering the sustainable use of natural resources by placing a price on the social costs of resource use. Issues of intergenerational equity and fairness are also relevant – for example, regarding the extent to which tax settings affect the rate of depletion of non-renewable natural resources.

30. Assessments of natural capital impacts will be particularly relevant to the Group's discussion of environmental taxation, but the Secretariat will also note other natural capital impacts as they arise in the course of the Group's work.

4.3 Interconnections between the four capitals

31. One important consideration in applying the Living Standards Framework is that the four capitals do not stand separately: they are interconnected, as can be seen by the fact that some of the issues identified above are relevant to more than one capital. The Secretariat will note these interconnections as they arise.

5. Conclusion

32. The Group will need to decide on its preferred framework for evaluating tax reform. Whichever assessment framework is chosen will be used to frame and shape all subsequent advice provided by the Secretariat to the Group.

33. In light of the Group's initial discussion on the subject, the Secretariat proposes the following approach to the assessment framework:

    - The Group can use the Living Standards Framework 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 will be assessed against the established principles of *efficiency and growth*, *equity and fairness*, *revenue integrity*, *fiscal cost*, *compliance and administration cost*, and *coherence*.

    - The Secretariat will also apply a Living Standards lens 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.

34. The Group is asked to decide whether it would be comfortable using this approach.

Appendix: Assessment Templates

Tax Principles Assessment

Impacts [Identify and list impacts under the headings below] [Note timing of impacts, if relevant]	Magnitude	Assumptions and evidence [Quantify if possible, use ranges where appropriate.]	Evidence certainty
Efficiency and growth			
[Impact 1]	H	[Any relevant assumptions]	H
[Impact 2]	M	[Any relevant assumptions]	M
[Impact 3]	L	[Any relevant assumptions]	L
Equity and fairness			
[Impact 1]	H	[Any relevant assumptions]	L
Revenue integrity			
…			L
Fiscal cost			
…			L
Compliance and administration cost			
…			L
Coherence			
…			L

Four Capitals Assessment

Impacts [identify and list impacts under the headings below] [Note timing of impacts, if relevant]	Magnitude	Assumptions and evidence [quantify if possible, use ranges where appropriate]	Evidence certainty
Social capital			
[Impact 1]	H	[Any relevant assumptions]	H
[Impact 2]	M	[Any relevant assumptions]	M
[Impact 3]	L	[Any relevant assumptions]	L
Human capital			
[Impact 1]	H	[Any relevant assumptions]	L
Financial and physical capital			
…			L
Natural capital			
…			L

Complementarities and trade-offs

[Note in narrative form whether there are any significant trade-offs or complementarities in the way the stocks of capital are affected.]

Prompting questions to apply a ‘capitals’ lens to individual proposals

General questions for the capital assessment

- Will the proposal increase or reduce the stocks of the four capitals that are necessary to support living standards?
- When are these effects likely to crystallise: over the short-, medium-, or long-term?
- Are there any trade-offs or complementarities in the way the capitals are affected?

Prompting questions for specific capital stocks

Social capital

- Will the proposal affect trust and confidence in Government?
- Will the proposal have a disproportionate impact on a particular community or group?
- Will the proposal have any implications for the Crown-Māori relationship?

Human capital

- Will the proposal affect incentives to work or to increase skills?
- Will the proposal affect people’s ability to participate in society?
- How will the proposal affect the material standard of living of groups/individuals?

[Note: In most cases, there is likely to be significant overlap with the ‘equity and fairness’ and ‘efficiency and growth’ assessments under the established principles.]

Financial and physical capital

- Will the proposal affect incentives to save or incentives to invest?
- Will the proposal generate distortions in savings and investment patterns?

[Note: In most cases, there is likely to be significant overlap with the ‘efficiency and growth’ assessment under the established principles.]

Natural capital

- How will the proposal affect stocks of natural capital?
- Will the proposal encourage the efficient use of natural resources? (i.e. technical, allocative and dynamic efficiency)
- Will the proposal encourage the sustainable use of natural resources?
- How will the proposal affect the rate of depletion of non-renewable resources?

Presentation of impacts

- To what extent have these effects already been captured by the assessment against the established principles?

If all relevant impacts have already been captured by the assessment against the established principles, provide a brief summary of these impacts against the capitals for completeness only.

References

Victoria University Tax Working Group. (2010). *A Tax System for New Zealand's Future: Report of the Victoria University Tax Working Group*. Retrieved from https://www.victoria.ac.nz/sacl/centres-and-institutes/cagtr/pdf/tax-report-website.pdf