Tax Working Group Public Submissions Information Release

Release Document

September 2018

taxworkingroup.govt.nz/key-documents

Key to sections of the Official Information Act 1982 under which information has been withheld.

Certain information in this document has been withheld under one or more of the following sections of the Official Information Act, as applicable:

[1] 9(2)(a) - to protect the privacy of natural persons, including deceased people;

[2] 9(2)(k) - to prevent the disclosure of official information for improper gain or improper advantage.

Where information has been withheld, a numbered reference to the applicable section of the Official Information Act has been made, as listed above. For example, a [1] appearing where information has been withheld in a release document refers to section 9(2)(a).

In preparing this Information Release, the Treasury has considered the public interest considerations in section 9(1) of the Official Information Act.

SUBMISSION TO THE TAX WORKING GROUP

BY DON BRASH

I appreciate the invitation which the Tax Working Group has extended to all New Zealanders to "share their own views about what is working – and what is not – in the current tax system". I wish to comment on several issues, some of them related to each other, some quite distinct. In particular, I will comment on:

1. GST
2. Company tax, including the taxation of businesses owned by charities
3. The taxation of savings
4. Tax and the growing inequality of wealth in New Zealand
5. Taxes designed to influence behaviour

GST

In recent years, several political parties have toyed with the idea of exempting items from GST – perhaps food, perhaps just fruit and vegetables, perhaps sanitary items.

I strongly urge the Working Group to resist these calls on three separate grounds.

First, once some items are exempted from GST, the political pressure to exempt other items – perhaps children's clothing, doctors' bills, dental bills, books, local body rates – would be very considerable. This would almost inevitably involve a considerable loss of revenue, and quite probably an increased rate of GST on the items still caught in the net.

Second, while it is certainly true that low income people spend a significant proportion of their income on, say, food – providing the logic for exempting food from GST – most of the money spent on food in the community as a whole is not spent by low income people, but by middle and high-income people. Thus, exempting food from GST would involve a considerable loss of revenue relative to the benefit accruing to low income people. It would be much more efficient to help low income people directly by direct income transfers than by exempting food (or similar items) from GST.

Third, many of those who advocate exempting food and other specified items from GST think of GST as just like a retail sales tax, and of course it is not. Yes, both GST and a retail sales tax are levied on sales to final consumers but GST is also levied at every stage of production, with those producing "intermediate goods" (prior to final sale to consumers) claiming back the GST paid in acquiring the materials, components and services used in producing those goods. This is an extremely simple process when there are very few exemptions in the GST system, but becomes markedly more complex as exemptions are added to the system.

When GST was first introduced in New Zealand in the mid-eighties, the instruction from the Minister of Finance to the committee which designed our GST was to minimize the compliance costs which would face small businesses as a result of the introduction of the tax. It was easy to see that that was best achieved by having virtually no exemptions. As a consequence, New Zealand's GST is widely regarded as one of the best in the world.

Company tax, including the taxation of businesses owned by charities

In recent years, many countries have reduced the taxation on corporate profits, with the sharp reduction in the US corporate tax rate to 21% being just the latest move in that direction. At 28%, our company tax rate is now above the OECD average, and well above some of the other countries we are sometimes compared with (though currrently still lower than the company tax rate in Australia).

These comparisons with international company tax rates are a bit misleading, in that New Zealand (and Australia) have dividend imputation regimes which shelter shareholders from the double taxation of company profits. But I nevertheless tend to favour some lowering of the company tax rate because I suspect the "headline rate" remains relevant, particularly for foreign investors contemplating investment in New Zealand.

Moreover, there is a reasonable literature which demonstrates that a significant part of the incidence of the company tax rate is borne by wage-earners, so that lowering that rate would, by encouraging more investment, have some positive benefit for wage-earners.

I would urge the Working Group not to advocate lowering the company tax rate only for small companies, up to some specified size. That would potentially increase compliance costs as larger companies sought, by appropriate restructuring, to be taxed at the rate applicable to small companies.

One of the curious anomalies in the taxation of corporate income is the exemption from tax of income earned by companies owned by charitable organisations. This exemption has been in place for a considerable time and I do not know the background to it. But it is entirely unclear to me why Sanitarium, for example, should be exempt from tax while Kellogg's is not; or why a bus company owned by an iwi should be exempt from tax while NZ Bus is not. At very least the exemption should extend only to the income distributed by these businesses for charitable purposes, though it is certainly hard to see why simply distributing profits to individual members of, for example, an iwi should be treated in a preferential manner as compared with dividends paid out to ordinary shareholders.

The taxation of savings

In the late eighties, I chaired several consultative committees on taxation for the Minister of Finance, one of which dealt with the appropriate tax treatment of life insurance and superannuation.

As members of the Working Group will know, the taxation of savings in New Zealand differs from the treatment in most other developed countries.

In New Zealand and in most other countries to the best of my knowledge, "ordinary savings" into a bank account are made out of tax-paid income; tax is levied on the interest paid; but when funds are withdrawn from the bank they are not subject to tax – Taxed-Taxed-Exempt, or TTE in the jargon.

But in many (perhaps most) countries there is a preferential tax regime for long-term, or superannuation, savings, with contributions often being a deductible item from current income, with the income accruing in the superannuation vehicles being either completely exempt from tax or taxed at a preferential rate, and with payments received in retirement again often being taxed at a concessional rate.

As I recorded it in my autobiography,

The committee [I chaired] debated this issue at length, and eventually decided that, while TTE is indeed the approach used to tax all other forms of saving, there was a case to be made for a different approach to taxing savings which were going to be locked away for many years, indeed decades. We recommended that people should be able to save into retirement income funds, what we referred to as RIFs, out of *pre-tax* income, that income within the funds should be taxed at the company tax rate (then 28%) because of the difficulty of taxing that income at the rate relevant to each individual, that 25% of the benefits could be paid out in lump sum form without incurring tax, but that the balance of the benefits should be taxed in the hands of the recipients as ordinary income – what we referred to as a "modified ETT" system.

Our reasoning was partly that giving the "E" at the start of the savings process would provide a strong inducement to save, and that was appropriate given that saving into a pension fund is quite different from saving into a bank account, where savings can be withdrawn at any time. Moreover, allowing the "E" only at the end of the process in, say, 40 years' time, as the Government had proposed, meant that savers would be vulnerable to some *future* government deciding to tax withdrawals from the pension fund, particularly if withdrawals were taken in the form of an annuity, with the result that the taxation of pension funds would end up as TTT.

Moreover, we argued, TTE and ETT are equivalent in terms of tax revenue received by the government assuming income tax rates remain unchanged, so government would be able to provide a considerable inducement to long-term saving without any loss of the present value of revenue.

Alas, of all the recommendations made by the four consultative committees which I chaired, this was the only significant one which the Minister rejected. The rejection was partly to maintain consistency with the way in which other forms of saving were taxed and partly to avoid channelling too much of the private sector's savings towards the insurance industry, which Roger Douglas felt had done a very poor job of investing the funds backing existing pension schemes.

Of course, I do not know how the introduction of an ETT regime for superannuation saving would have affected New Zealand's subsequent saving performance, though it is hard to see why there would not have been a considerable increase in saving. The Opposition National Party briefly toyed with the idea of introducing an ETT regime for superannuation saving, but dropped the idea after winning election in late 1990.[1]

I am not now in any sense well informed on the current debate on the taxation of savings, but I tend to agree with those who argue that the relatively favourable tax treatment of savings invested in, say, owner-occupied residential property (TEE) is a contributing factor in the currently extreme level of house prices. If it is politically impossible to touch the second and third E, then perhaps there would be merit in making the taxation of other forms of long-term saving more attractive.

Some recent commentary[2] has suggested that, if the Government were to introduce a capital gains tax in response to recommendations from the Tax Working Group, "it was likely that tax on both capital gains and interest would be adjusted to take inflation into account", a view attributed to PwC tax expert Geof Nightingale, himself a member of the Tax Working Group.

I understand the logic of that, and the political appeal of adjusting the tax on interest for the effect of inflation. But as a former member of the Committee of Inquiry into Inflation Accounting (usually referred to as the Richardson Committee), I hope the Tax Working Group also recognises that if interest *received* should be adjusted for inflation for tax purposes, interest *paid* should also be adjusted for inflation for tax purposes.

Adjusting the tax system for inflation is a complex business, as the Richardson Committee concluded. In the late seventies, when the Richardson Committee was studying this issue, adjusting the whole accounting system for inflation seemed to make sense because of the quite serious distortions being caused by the relatively high inflation which prevailed at that time. Unfortunately, then Minister of Finance Muldoon was pretty certain that he was not going to adjust the tax system for the effects of inflation, so that the appeal of inflation accounting was short-lived. The subsequent Labour Government implicitly decided it was better to eliminate inflation.

---

[1] *Incredible Luck*, Don Brash, 2014, pp.55-56.

[2] "Silver lining from capital gains tax", *Sunday-Star Times*, 25 March 2018, p. D3.

Tax and the growing inequality of wealth in New Zealand

There has been increasing public focus on growing inequality in New Zealand. In fact, as members of the Working Group no doubt know, there has been no appreciable change in pre-housing-cost *income* inequality in New Zealand over the last two decades.

But there has been a marked increase in *post*-housing-cost income inequality as a consequence of the failure of successive governments to do anything meaningful to deal with the causes of the enormous escalation in house prices over the last 20 years or so.

As indicated above, that has no doubt been influenced in part by the favourable tax treatment of investment in residential property.

It also seems very likely that there has been a considerable increase in *wealth* inequality over the last decade or two as a consequence of the explosion in house prices: those lucky enough to have owned a home, or better still several houses purchased with borrowed money, have become vastly wealthier than those who did not own a home.

The question which the Working Group has been tasked to consider is what role the tax system has played in allowing this situation to develop, and more particularly what role the tax system should be playing in seeking to redress some of the wealth inequalities which have arisen as a consequence.

It seems clear that while the tax system may have encouraged the escalation in house prices in recent years, the basic causes of the escalation relate to local government planning and consenting procedures, as the Productivity Commission and others have argued.

But the combination of those planning rules (including in particular the tight constraint on residential land in Auckland created by the Metropolitan Urban Limit, or Rural Urban Boundary) with the construction of major infrastructure funded by other taxpayers and ratepayers has produced a situation where some people have become extremely wealthy with minimal personal effort and absolutely no tax liability.

In 2013, there was an understandable public outcry when 29 hectares of land in the Auckland suburb of Flat Bush, purchased 18 years earlier in 1995 for

$890,000, was listed for sale at $112.6 million – the direct result of the Metropolitan Urban Limit and the construction of infrastructure paid for mainly by other ratepayers. The gain on the sale would almost certainly have been totally tax-free.

I am not sufficiently familiar with the relative merits of land taxes, capital gains taxes, wealth taxes and "uplift taxes" to express an opinion on which of these options is the best under the circumstances, but there is clearly something inherently unjust to be taxing the ordinary wage earner on his or her hard-won income at up to 33% while not taxing at all the owner of property which hugely increases in value through no effort on the part of the owner at all. That is especially true when the increase in value is a direct result of the construction of infrastructure funded by others.

Taxes designed to influence behaviour

Since the introduction of GST in 1986, New Zealand has had few taxes designed to influence behaviour – essentially, only taxes on alcohol, tobacco, and petrol, with petrol being taxed not so much to influence behaviour as to provide a direct funding mechanism for the road network.

Taxes on alcohol are widely accepted as a way of raising revenue to compensate for the serious social problems which alcohol can create and I certainly have no problem with such taxes.

But I have a good deal of sympathy with those who believe that taxes on tobacco are now having more negative effects than positive ones. Evidence suggests that cigarette taxes are no longer producing a significant reduction in smoking but are putting severe economic pressure on the budgets of low income nicotine addicts as well as producing a large number of aggravated burglaries on dairies. In my view (and I am a non-smoker), there would be merit in freezing cigarette taxes at current levels rather than further increasing those taxes, or indeed even somewhat reducing them. I understand that the revenue raised from cigarette taxes now considerably exceeds the cost of treating the negative health consequences of smoking.

There is considerable public support for taxes on sugar, and in particular on sugary drinks. While New Zealand clearly has a serious problem with obesity, and that would seem to support a tax on sugary drinks, I understand that a number of studies suggest that such taxes have little or no effect in terms of reducing the consumption of sugary drinks. In the jargon, the demand for sugary drinks appears to be very inelastic.

Finally, one of New Zealand's challenges, especially in Auckland, is severe traffic congestion. The Auckland Council appears to believe that providing more public transport and more cycle-ways will materially improve the situation. But given the relatively low density of Auckland's population and the unpredictability of Auckland's weather, neither public transport nor cycle-ways will be an adequate response to congestion. Part of the solution must surely be congestion charging, hopefully modelled on Singapore's successful system.

25 March 2018