Tax Working Group Public Submissions Information Release

Release Document

September 2018

taxworkinggroup.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

Hon David Butcher
[1]

Responses to the Working Group Background Paper

Introduction

Thank you for the opportunity to make a submission on the best tax regime for New Zealand.

The Tax Working Group Background paper analyses the merits and gaps remaining in New Zealand's approach to raising government revenue. Past governments have bequeathed New Zealand with one of the best taxation systems in the world from the points of view of fairness, simplicity, efficiency, but it is capable of improvement, particularly in spreading the base of taxation to include wealth and property.

My submission follows the layout of the background paper. My intention is to draw attention to the major issues and to recommend more detailed studies where my personal experience cannot offer an informed opinion.

Future environment

This section seeks comments on the main risks, challenges, and opportunities for the tax system, how the system should evolve to address them and how tikanga Māori could help create a more future focussed tax system?

The background paper lists perceived risks to the system from changing demographics and fiscal pressures, the changing nature of work, the growth of self-employment, the threat to the tax bases, from technology, company tax pressures, environmental challenges, concerns about inequality, and changing patterns of globalisation.

Other issues that need to be considered include: the effectiveness of taxes on income on the one hand and the lack of attention to inheritance and gratuitous wealth accumulation on the other. The last thirty years has seen many tax expenditures (or deductions against tax liability) removed from the tax law, but bids to reintroduce new ones remain a threat to the tax base.

The most disappointing aspect of the system is that some of the nation's poorest citizens pay the highest effective marginal tax rates, particularly when incomes are a mixture of tax and benefit. If there are moves to increase the taxation of wealth, including land, the unique problems associated with collectively owned, usually Maori land need to be addressed. `

Overall, the working group should be aware of the need to ensure the various taxation methods are mutually reinforcing and minimise opportunities for arbitrage, i.e. moving income from a company to private taxation streams.

Purposes and principles of a good tax system

This section seeks comments on principles used to assess the performance of the tax system and comment on the definition of 'fairness' in the context of the tax system? What would a fair tax system look like?

Good System

The background paper provides the standard test for the quality of a tax system:

- Efficiency: Taxes should minimise their cost on society, be neutral among investments options, unless justifiable.
- Equity and fairness: Horizontally: treat equally taxpayers in similar circumstances and Vertically equity (fair treatment of those with differing abilities to pay tax).
- Revenue integrity: Taxes should minimise tax avoidance and tax arbitrage and provide a sustainable revenue base for the government;
- Fiscal adequacy: Sufficient revenue should be raised to meet government expenditure.
- Costs: Costs of complying with the system and administering it should be kept to a minimum.
- Certainty: taxpayers should know the tax due.
- Coherence: Individual tax measures should reinforce the effectiveness of the whole system.

Ramsey Pricing

The issue is how can taxes be extracted from the economy with efficiency, equity, integrity, adequacy, certainty and coherently at the lowest possible cost. Similar issues are raised in regulatory economics. *RAMSEY PRICING* states that for any monopoly, the price mark-up should be inverse to the price elasticity of demand: the more elastic demand for the product, the smaller the price mark-up. This principle was originally recognized by Frank P. Ramsey who maintained that the efficiency of taxation is increased by adopting a similar rule for taxation: the tax collector is the monopoly collector and citizens are the consumers. The principle is that taxes are most efficient when taxpayers have a limited ability to avoid tax by switching purchases to alternatives.

Ease of administration and simplicity of definition of the tax base are critical elements of a good system. The Working-group will recall the derision heaped upon the opposition's X-tax proposal at the 1987 election. The principal reason was the potential it offered to complicate collection, increase cost of collection and create definition problems: e.g. cake is tax free (food), chocolate is not (confectionary); what about a chocolate cake?). In those parts of the World where similar sales taxes remain in place and in India where a more complex system has recently been agreed, they are essentially the system New Zealand abolished in 1986. In those days when ever New Zealanders bought something a "helpful" friend would say: "You should have told me, I could have got it for you at the wholesale price!"

New Zealand's 'broad-based, low-rate' system, with few exemptions for GST and income tax, is widely regarded as a system that is probably as close as any others to exhibiting the characteristics of a good system. For this reason, it is difficult to increase efficiency, or fairness. The current mix of direct and indirect taxation has been in place for over thirty years and few practical alternatives have ever been suggested. Accordingly, much attention should be focused on improving compliance and coverage. However, while New Zealand's mix of taxes is one of the best it can be added to. Below are suggestions regarding taxation of wealth and property and ensuring the system is progressive.

Looking to the future, it is my submission that our current mix of indirect and direct taxes remains the approach that best achieves efficiency, equity, integrity, adequacy, certainty and coherence at the lowest possible cost, although it could be enhanced further by taxation of large accumulations of wealth and property, thereby ensuring the whole system is progressive.

Behaviour Modification

Taxes that intentionally modify behaviour, whether it be discouraging the use of tobacco, sugary drinks, alcohol or even petrol for cars are best applied as excise duties (so-called "sin" taxes). Duties are separate from the Pay as you earn (PAYE) aspects of the system. Their base is clear, the revenue collected can be counted easily and increasing them (or decreasing) them can be debated sensibly without undermining other aspects of the system.

Similarly, in 1989 New Zealand moved to a system of TTE for long-term savings: savings are made from Tax-paid income; savings and investment funds are Taxed as they earn profits as are other businesses; the proceeds of the fund are tax Exempt when withdraw as are other business sales.

Some recent research[1] has linked TTE to New Zealanders' fondness for investment in housing rather than other forms of saving and have maintained that this is behind the rapid increase in house prices. It is shown that other countries use an EET (Exempt, Exempt, Taxed) system and New Zealand is unusual. The evidence for this claim weak is weak as many of the nations with EET systems have also suffered rapid price increases for housing although those in New Zealand have been larger.

My recommendation would be that the research be examined, maybe in conversation with its author and if considered worthy of further investigation, additional research should be commissioned.

[1] Tax reform and the housing market - Andrew Coleman – presentation to Law and Economics Meetings in Auckland and Wellington, March 2018

Results of the current system

This section asks if the current system strikes the right balance between productive and speculative activities and if not, what changes should happen? It also refers to the costs on business and the maintenance of natural capital. It further goes on to ask if there are businesses benefiting from low effective tax rates because of excessive deductions, timing of deductions or non-taxation of certain types of income?

False Distinction

There are many issues involved in this section. My first comment is that the distinction between "productive and speculative" is unhelpful. It is reminiscent of a comment by a member of Parliament in 1989 "If it is tangible and essential we should produce it." His statement overlooked the necessity for any unsubsidised business activity to make a profit.

A focus on TANGIBILITY was the attitude that led to butter mountains in Europe, freezing chambers full of sheep meat that could not be sold and subsidising the conversion of excess supplies of meat into blood and bone fertiliser in the early 1980s. All these items met the test of tangibility and essential, but many were far from profitable or sensible to produce in the quantities achieved.

Similarly, talking about "productive" creates a bias in favour of tangible production and manufacturing activities as opposed after sale services and ongoing consumables. The trend in manufacturing is for production of tangible goods, e.g. printers to be a commodity and the associated maintenance, updating, training and other services to be the principal revenue stream[2].

Arbitrage

There are many people who would regard any "arbitrage" buying items or properties cheap and selling them on at a profit as speculative and believe all such speculation should be discouraged. This language carries an implicit assumption that anyone selling an item that someone else can sell for a higher price is being "ripped off". There are of course examples of people lacking market information making unwise decisions to sell below what something is worth to some other party.

By contrast, there are billions of day-to-day examples of people trading, for example, currencies, where both parties are reasonably well-informed, and transactions only take place where both parties believe the transaction will meet their immediate needs and make each of them better off from their own perspective.

Taxation of Trading

Furthermore, it is important to realise that in the mind of the buyer what they intend to do with an item is an important consideration when deciding to buy it. An example is when Post Bank was sold for NZ$600 million in 1988. The bank had been all-but bankrupt, had lost market share and but corporatization was gradually halting the decline. However, Ministers were told that the purchaser, ANZ Bank had recently installed a new computer system and it had extensive spare capacity. By offering a higher price for Post Bank, ANZ immediately transferred all customers to the one system and made better use of its own system with very little capital expenditure. All other bidders would have had to invest in a whole new system, so it was a commercial decision to bid more to win the company and increase the use of the new system.

There is no conceivable policy to ensure that nobody ever makes and mistake and there is little or no way the tax system can improved that situation[3]. What the question should be focusing is: how to ensure that all profits from trading activities are within the taxation net. If the issue is put in this way, then it may be possible for the experts in collecting taxes to identify ways of improving the current

---

[2] In 1990, my first laser printer cost me $4000. Recently, a Canon Printer with far greater capacity and flexibility cost $69! However, the cartridges for the printer cost $50 each, which is where the manufacturer makes money.

[3] The prize must go to the Antiques Roadshow case of a person who gifted a plant in an old vase to a charity shop, which a lucky buyer bought for £1, the new owner had the vase assessed and it sold at auction for £26,000!

collection system. The various devices being proposed for collecting GST from internet purchases are examples using modern technology to broaden the base of the system.

The government should be encouraged to ask officials and expert to research the taxation of trading (including houses, foreign exchange and other traded items) and report back.

Tax Expenditures

My first experience with tax expenditures was when I took out an endowment policy in 1974 as part of my retirement plan. I obtained a tax deduction, part paying for the policy premiums. Colleagues at the meat works could not afford an endowment policy and consequently got no support at all for their retirement plans. Using a tax deduction to subsidise the retirement plans of the rich was contrary to an equitable tax system. The deduction for insurance premiums was abolished in by the Lange Government in 1984-5.

The obscenest example of this approach is in the USA today. Thanks to long-standing tax deductions for interest paid on mortgages, Hollywood Millionaires get deductions against their tax liability for the interest they pay. This encourages them to buy fabulous mansions, utilising hundreds of thousands of $ of tax deduction subsidy to do so.

The people on benefits who got housing mortgages to buy their humble 2-bedroom homes, before the GFC, would have smaller mortgages, relatively smaller interest payments and got next to nothing. The most recent tax changes have eliminated subsidies for public housing. Tax relief for the interest the rich pay on borrowed money to buy their homes remains in place.

Rebates not Deductions

This unfair result is an argument for any "assistance" to be paid as a REBATE. A rebate is a defined amount paid to parties that qualify. To quote the first example, with a DEDUCTION the taxpayer with superannuation or insurance of $000's would get far more support than my former colleagues who had either a tiny retirement superannuation fund or none. With a cash REBATE, the assistance to both parties would have been identical and proportionately more beneficial to the poor.

Public understanding of this effect is very low. I recall reading a letter to the editor in which an elderly couple promised to vote against the Kirk government because the first Rowling Budget changed their "spouse" deduction (then about $280 against tax). They claimed it had been "reduced" to a $150 rebate. In fact, of course they were much better off with the rebate as it is probable their tax would have been at the low end of the scale and they would have got the full benefit of the rebate. Any switch to rebates of this kind would need to be associated with a wide public information programme.

Rebates can also be a precursor of a Universal Basic Income (UBI). I am aware that a UBI is beyond the scope of the working-group's mission. However, it is a clear example of ensuring that the system is coherent, and all aspects point in the direction of confining assistance to those who need it most.

Business Deductions

A further example of the same principle is the raft of incentives and deductions that existed in the Muldoon era before 1984. Until 1984, there was little, or no attention focused on the issue of tax expenditure. The 1984, budget was the first to address the issue and provided a table with estimates of the revenue lost for each deduction, many of them related to farm land. They were significant contributors to the rapid increase in the value of farm land in the early 1980s. In the period 1984 to 1990 many of the tax expenditures, including most of those for farming, were removed.

This was an important reform and was widely ignored by academic studies and pro-poor commentators. The importance of it can be seen from the experience of a relative who worked as a recruiter for the Statistics Household Expenditure Survey. In the Rodney district of Auckland, she visited house after house with large rooms on two or more floors, Range Rovers and Jaguars in the garage next to the tennis court and swimming pool.

By claiming all the above items as business expenses (e.g. the pool was described as a reservoir in case of fire) at that time the taxpayer received 66 cents in the dollar deduction against their normal professional income for every $1 spent. The owners of the Range Rovers did have taxable incomes, most less than $1000, and at that time managed to qualify for low income assistance. One famous commentator claimed they were living in poverty because of their low taxable incomes.

Rich and Influential

One of the remaining threats to the tax base, is that the rich and the influential will lobby strongly to have deductions reintroduced. The rich and influential can afford to hire lawyers, accountants and lobbyists. The representatives of the poor cannot.

Relatively low rates of tax and equality of tax rates between businesses and private individuals made the benefits of lobbying relatively low and much tax evasion though business expense deductions ceased to be a worthwhile activity. Unfortunately, when the personal maximum tax rate was raised to 39%, with the intention of increasing the progressivity of the system, the evasion business was resurrected, and the outcome was the opposite of the one intended. It increased the value of many deductions.

My suggestion is that further work be commissioned to narrow the scope of the remaining tax expenditures and where assistance is to be delivered it should be by way of rebate so that all taxpayers qualify.

Thinking outside the current system

This section focuses on inconsistencies with the current tax system and seeks advice on how the priority to address them. Apart from the issues addressed above the main inconsistencies in the current tax system are three and it is important to address all three:

(1) There is a major disparity between the effectiveness of taxes on income on the one hand and lack of attention to total wealth, inheritance and gratuitous wealth accumulation on the other;
(2) Effective marginal tax rates: some of the poorest citizens in New Zealand pay the highest effective marginal tax rates.
(3) The various methods of taxation need to be mutually reinforcing to minimise opportunities for arbitrage, i.e. moving income from a company to private taxation streams.

Taxes on Wealth

Until 1991, New Zealand had a Land Tax System. The scope of the tax was expanded in 1989, as the 1987 international crash had caused a revenue shortfall, although the abolition of the system was promised for 1991. The "new" taxpayers, people who had never been asked to pay it previously were generally outraged as the government had been focusing on reducing direct tax rates for the reasons outlined above and saw the sudden new tax invoice as backtracking on the previous policy.

For this reason, while the case to address the taxation of wealth accumulation is strong it is something that must be carefully managed. The case for such taxes is set out very clearly in Fabian Tract 388[4] and there is good reason to anticipate that the situation in the United Kingdom in 1968 was worse than it is in New Zealand today and is probably worse than that now in the United Kingdom.

Essentially, the case made is that much wealth is stored in assets that are underused, paintings, jewels, mansions and elaborate vehicles and leisure goods. It proposed a very low tax on such property, starting at per annum levy of 1 percent on wealth of exceeding approximately $2 million in today's money, rising to a maximum of 5 percent for accumulations of wealth above $ 20 million. This would be combined with a presumption that any asset not declared is not owned and would be returned to the revenue authorities.

To ensure widespread acceptance of the tax the individual exemption would be sufficiently high to exclude the entire middle class and focus on the small group of owners of wealth, often inherited through no effort of the current owner. It would not raise much revenue initially, but every year that passes would increase the number of people affected. It would encourage those affected to dispose of property they under-use, which in turn would be acquired by others who will make better use of it.

---

[4] *The case for Capital Taxes*; Fabian Tract 388 (1968) by Oliver Stutchbury https://digital.library.lse.ac.uk/objects/lse:rof509gen accessed 19-04-2018

In my view such a tax would be easier to administer, easier to calculate and be more certain in application that a capital gains tax. As a further part of the implementation package there could be pledge not to introduce a capital gains tax. A further step to win acceptance of a wealth tax would be a further a reduction in company tax to the level of our trading partners would also be welcomed widely. Should the government at some stage open the possibility of moving from taxation of income to assets, the existence of a wealth tax would make the adjustment easier.

The practicality of the proposed wealth tax would need further study, but would score very highly in improving the coherence of the system.

High Marginal Tax Rates

One impediment for people moving from a benefit to paid work is the fact that some beneficiaries with housing allowances, can soon be in the position of paying an effective tax rate of more than 100% of any additional earnings. If a taxpayer is simultaneously paying ordinary taxes and losing the whole or part of a current benefit it is inevitable that the effective tax rate will be higher than any taxpayer earning the same amount from employment alone or on a benefit alone.

A standard rebate is one way to address this problem. The UBI simply takes the concept much further. It is not an easy problem to address, but our experience with Working for Families is instructive. A Family tax credit (FTC) is paid regardless of the source of income. In-work tax credit (IWTC) is an additional payment for families who normally work a minimum number of hours each week for salary and wages but are still on very low incomes.

Detailed research is required into how a system based on standard rebates can be improved to ensure that families receive sufficient incomes and have sufficient incentives to undertaken paid when it is available.

Progressive Income Taxes

In the mid-1960 and 1970s the author worked in the Tomoana Freezing Works in his summer holidays. His father worked in the same shed and managed to persuade the leading hands to find places for him in the midday gang (to clean after the morning's work) and the late gang (to clean after the day's work concluded). In the 1975 Budget the Minister of Finance, the late Bob Tizard put in place a multiple step scale of taxes on income, collected through the PAYE system.

The PAYE assesses each week's pay as though the amount earned that week would be representative of every working week of the year. His colleagues, whose main employment was the meat works, complained incessantly of the "Tax on Overtime". Many of those who grumbled about overtime tax took off to Australia.

However, there was no specific tax on overtime. Should the amount of PAYE tax collected amount to more than the taxpayer's total liability, the person affected should submit a return and receive a refund.

But, some of the workers were there were illiterate or had no access to anyone who could help them fill out their return. Consequently, many lost any interest in the midday gang and the late gang. What this showed me was that using the PAYE scale to create a progressive system could be counter-productive for the poor or people uneducated in the finer points of tax returns.

What is important is for the tax system as whole to be progressive. The number of steps in the scale should be few and the top rate should be internationally competitive. All people able to work for a living should be encouraged to do so and penalised as little as possible by high rates on increments. By contrast, tax "perks" and deductions described above should be the tools to make the system progressive.

Specific challenges

Submissions have been asked to include responses to certain specific challenges.

The following table sets out the specific questions asked and my responses.

Question	Response
How, and to what extent, does the tax system affect housing affordability for owners and renters? Is there a case to change the tax system to promote greater housing affordability? If so, what changes would you recommend?	Traditionally, the tax system has treated investment in housing as a normal investment. Given the limited opportunities to invest in near sovereign quality investments housing is one of the few options available to savers. Allowing savers to invest in harbours, roads and local power companies will create other investment options
Should New Zealand introduce a capital gains tax (that excludes the family home)? If so, what features should it have?	A capital gains tax is not supported because it will generate little revenue and is very complex for taxpayers and advisers. It is also easy to avoid. A wealth tax would be more effective. Combined with a generous exemption for all taxpayers, would ensure that the super-rich, particularly those with inherited wealth are the principal payers
Should New Zealand introduce a land tax (that excludes the land under the family home)? If so, what features should it have?	Land should be one of the aspects of wealth included in the wealth tax proposed above. As noted above the introduction of a wealth tax would need to be managed very carefully and as far as possible should be revenue neutral. This means that an important function of the wealth tax would be spreading wealth more evenly rather than revenue collection alone.
What are the main opportunities for effective environmental taxation?	The guiding principle should be that parties that pollute pay sufficient penalties to clean up the mess, or preferably that an arrangement beforehand ensures that pollution does not occur: an example all water intakes for industry should be located downstream of effluent outfalls.
Should the tax system do more to support small businesses? Is there a case for a progressive company tax?	Until 1967 this was the case. The arguments for its elimination were strong then and remain strong now. A better alternative would be a limited tax credit or rebate for new business ventures, available to people moving into the private sector.
Should the tax system exclude some goods and services from GST? If so, what should be excluded? What else should be taxed to make up for the lost revenue?	Exclusions add cost, inconvenience, administration and definitional problems: cake is tax free (food), chocolate is not (confectionary); what about a chocolate cake? One of the benefits of the current system is that we do not have these problems

Conclusion

This submission has addressed both the merits and gaps remaining in New Zealand's approach to raising government revenue. Past governments have left us with one of the simplest and best taxation systems in the world from the points of view of fairness, simplicity, efficiency. Some improvements have been suggested and some suggestions have been criticised.

The system is capable of improvement, particularly in spreading the base of taxation to include wealth and property. However, consistency greatly eases the administration of the system.

My intention has been to draw attention to the major issues and to recommend more detailed studies where my personal experience cannot offer an informed opinion.

[1]

Hon David Butcher