

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.



Tax Working Group Secretariat
PO Box 3724
Wellington 6140
New Zealand

By email: secretariat@taxworkinggroup.govt.nz

SUBMISSION OF THE NEW ZEALAND TAXPAYERS' UNION TO THE TAX WORKING GROUP

Introduction

1. This is a submission of the *New Zealand Taxpayers' Union* to the *Tax Working Group* responding to the Working Group's *Future of Tax: Submissions Background Paper* (the "Paper").
2. We wish to appear before the Working Group.

LOWER TAXES, LESS WASTE, MORE TRANSPARENCY

WWW.TAXPAYERS.ORG.NZ

Contents of this submission:

Table of Contents

Section one: introduction and summary	4
About the Submitter.....	4
Overview and objectives of reform.....	4
Objectives of the Working Group	5
Possible objective one: changes to the tax system to tax New Zealanders more (raise more revenue)	5
Possible objective two: make tax system "fairer" (more equitable).....	6
Possible objective three: make tax system "better" (more efficient).....	6
Revenue neutrality	7
Section two: Income taxation	9
Fiscal drag: the under-arm bowling of our tax system	9
Experience in Canada: No taxation without indexation.....	11
Company taxation	11
Progressive company tax rates.....	12
Company tax cuts: international literature suggests wage earners benefit most	14
Full expensing of capital investment: the best idea in tax no one's heard of.....	14
Thin Capitalisation rules.....	15
Businesses owned by charities and Maori Authorities – removing the loopholes	16
Commercial business deemed 'tax charitable'	16
Race-based tax: Maori Authorisation	17
Section Three: Capital taxation	18
Why tax capital?	18
Inequality as a justification.....	19
Capital gains tax.....	20
Summary	20
Primary Residence Exclusion	20
Investment Effects.....	21
Accrual or realisation?	21
Sustainable revenue base: Capital gains taxes perform poorly.....	22
Land tax	22
Imputed income taxation	23
Section four: Taxes on savings and investments for retirement	26
Section five: Environmental taxes	28
Economic impact	28
Water taxation.....	28
Emissions taxation	30
Households finances.....	30
Benefits of environmental action	31

Section six: Behavioural taxes	32
Sugar taxes	32
Tobacco excise.....	33
Section seven: Varying GST	35
Section eight: Tax treatment of cryptocurrencies	37
Appendix 1: Specific answers to the Paper's "Questions for submitters"	39
Appendix 2: Key submissions	42

3. Key submissions are highlighted in the main body of the document, and also appended.
4. Attachments:
 - (a) Submitters' Annual Review
 - (b) Reports:
 - (i) *Five Options for Tax Relief in 2017*
 - (ii) *Fizzed out: Why a sugar tax won't curb obesity*
 - (iii) *Up in Smoke: the social cost of tobacco excise*
 - (iv) *Passive Income: How the Government uses smokers as cash cows*

Section one: introduction and summary

About the Submitter

5. Founded in 2013 by David Farrar and Jordan Williams, the *Taxpayers' Union* is New Zealand's largest taxpayer advocacy group, with more than 35,000 subscribed members and supporters.
6. The *Taxpayers' Union's* vision is a prosperous New Zealand, with efficient, transparent, and accountable Government. Our mission is: *Lower Taxes, Less Waste, More Transparency*.
7. The *Taxpayers' Union* is a member of *World Taxpayers Associations*: the global network of more than 55 taxpayer protection groups representing more than two million supporters in some 40 countries working together for lower taxes, limited and accountable government, and taxpayer rights.
8. A copy of the submitter's most recent Annual Review is enclosed with the hard copy of this submission.

Overview and objectives of reform

9. We largely support the Government's objectives outlined in the Terms of Reference for the Working Group. These are:
 - (a) a tax system that is efficient, fair, simple and collected (sic);
 - (b) a system that promotes the long-term sustainability and productivity of the economy;
 - (c) a system that supports a sustainable revenue base to fund government operating; expenditure around its historical level of 30 percent of GDP;
 - (d) a system that treats all income and assets in a fair, balanced and efficient manner, having special regard to housing affordability;
 - (e) a progressive tax and transfer system for individuals and families; and,
 - (f) an overall tax system that operates in a simple and coherent manner.
 - (g) The Paper encourages submitters to consider which of the principles and frameworks listed on page five¹ of the Paper are "the most important" criteria for assessing the costs and benefits of any proposed reforms. Any proposal will require trade-offs in achieving these criteria.
 - (h) Ranking these priorities in order of preference can aid in making those trade-offs, we submit they are in order of importance:

¹ We respectfully submit that it would be helpful if the Working Group's future publications included paragraph numbering, especially if the future papers pose questions within the body, in addition to listed questions submitters are asked to address.

- (i) Efficiency: minimise impediments to economic growth and avoid distortions to the use of resources;
 - (ii) Compliance and administrative costs;
 - (iii) Revenue integrity;
 - (iv) Coherence: ensure that individual reform options make sense in the context of the entire tax system;
 - (v) Fiscal adequacy; and finally,
 - (vi) Equity and fairness.²
10. Equity and fairness should be ranked last because of the inherently subjective value claims required in making assessments, while the other criteria can be judged more easily on an objective basis.
 11. If the Working Group are to go wider in their assessment criteria, we would support adding one more criterion: 'Honesty and Transparency' as a seventh criterion.
 12. 'Honesty and Transparency' in a tax system means that taxes should avoid being artificially increased due to factors outside taxpayers' control – specifically price and wage inflation – and similarly taxpayers should not be required to pay tax on adjustments caused solely by inflation.
 13. We provide further comments on this in our submissions on fiscal drag and taxes on savings and investment in sections two and four.

Objectives of the Working Group

14. In our view, based on the very broad Paper and associated communications, public calls for submissions and advertising, we think there are three broad objectives the Working Group will need to decide between three possible objectives.

Possible objective one: changes to the tax system to tax New Zealanders more (raise more revenue)

15. To date, most of the public comments by the Working Group's Chair have related to new taxes, or taxing more, particularly in relation to the anticipated increase in the burden of New Zealand Superannuation, with little identification or public discussion about what taxes could be reduced (or eliminated) to achieve fiscal neutrality.
16. With the Government's guidance in the Terms of Reference for tax revenue to remain at approximately 30% of GDP, we invite the Working Group to reject this objective.

² We note the Paper lumps procedural fairness in the broader equity and fairness category. While procedural fairness is an essential requirement for the tax system, we think this is largely about tax administration rather than the group's work in weighing up the broad objectives. We have therefore ignored this sub-criterion.

Possible objective two: make tax system "fairer" (more equitable)

17. Any proposed changes to make our tax system more equitable require a pre-determined notion of how to measure fairness. Evaluating how 'fair' our tax system is, or could be, is subjective and depends on the values of those making assessments.
18. Given different people have different values and different ideas about what constitutes fairness, we submit that as an appointed, rather than elected body, the Working Group is not well placed to make judgment calls about how the tax system could be changed to improve fairness in an income equality / redistribution sense.
19. Nevertheless, where the Working Group finds procedural unfairness; inequality between taxpayers in the same, or substantially the same position, or find that the tax system is not honest and transparent (and therefore not 'fair') the Working Group should not hesitate in making recommendations.
20. We recommend that objective two be secondary to objective three.

Possible objective three: make tax system "better" (more efficient)

We submit that the primary objective of the Working Group should be to recommend changes in the tax system that make it better – i.e. less damaging to the economy, society, and individual liberties; and more efficient.

What is a "better" tax system?

21. A better tax system is one that imposes fewer distortions and puts less pressure on the fundamental levers of economic growth. When we tax incomes and investment we clamp down on the incentive structures that provide for more productive jobs and higher incomes through time.
22. Based on the Paper and issues raised, there needs to be a much stronger focus from the Working Group on being ambitious and growing the economy in a meaningful way. Some households and business sectors could be made better off through changing the way we distribute the economy ("dividing the pie"), but only in a limited way.
23. By being ambitious (aiming to "grow the pie") the Working Group could improve levels of prosperity, without making value judgments about the pre-conditions for a more equitable society.

We submit that all changes considered and recommended by the Working Group identify whether they are likely to result in less dead weight loss, fewer economic distortions, and more incentives for economic, wage and income growth.

24. At a minimum, the Working Group should specifically take into account how new forms of taxation could impact productivity growth.
25. It has been widely acknowledged (and is discussed at length in this submission) that New Zealand suffers from poor productivity performance, contributing to a low wage environment.
26. Introducing new taxes (especially on production, or capital investment) without reducing tax in other areas could further damage New Zealand's ability to transition to a high-wage economy.
27. The Working Group's Chair has made clear that the Government needs to investigate new revenue streams in order to maintain social services in the presence of an aging population.
28. Leaving entitlements unchanged, an older population pushes up superannuation and health costs and shifts household income streams away from labour and towards capital, with the effect of reducing revenue streams for the Government.
29. But the Government should not implement tax policy changes today on the basis that additional revenue will be required in several years and should carefully examine re-structuring superannuation and healthcare to limit the fiscal damage of an aging population.
30. Similarly, we urge caution on making changes on the basis of anticipated technological change. For the last decade public policy makers have feared widespread job losses due to artificial intelligence and robotic technologies. So far that fear has not materialised – in fact the United States (a jurisdiction with much higher rates of capital investment, and therefore somewhere we would expect to be a precursor to these issues in New Zealand) has recently experienced record job growth.
31. While we do not object to the Working Group considering the impact of technological changes on the tax system, we submit that the baby should not be thrown out with the bathwater for the sake of preparing for a 'tomorrow' which might not come, or be much further away than assumed. This is particularly so if the proposed changes impose a real economic cost now.

Revenue neutrality

32. We believe that new taxes should only be introduced when there are equal decreases in other taxes - i.e. reforms should be 'fiscally neutral'.
33. Revenue neutrality should be a necessary pre-condition for the introduction of new taxation. All forms of taxation cause distortions, so the introduction of new taxes in absence of reducing existing taxes imposes an additional burden on taxpayers and introduces new economic distortions.
34. We have closely followed the public comments by the Working Group's Chair, the Minister of Finance, and the Prime Minister, in relation to whether reforms adopted by the Government from the Working Group are likely to be fiscally neutral.
35. Accepting those media comments on their face value, implicit to all of the analysis in this submission is that any proposed increase in taxation will be offset by tax cuts in other areas, such that the final change will be revenue neutral.

36. Nevertheless:

Where new taxes (including reforms to existing taxes which are likely to increase the overall burden of the tax system) are recommended by the Working Group, we submit that the Working Group should identify other areas where the burden can be reduced to compensate taxpayers.

37. This submission is consistent with the Government's third objective listed in the Working Group's Terms of Reference.

Section two: Income taxation

Fiscal drag: the under-arm bowling of our tax system

38. The current failure to index income tax thresholds see tax increases every year without any discussion in Parliament or the public sphere. It is, we submit, a sneaky and pervasive rust in our tax system. It raises taxes over time.
39. Fiscal drag or "bracket creep" is the result where, because of inflation - the value of money decreasing over time - individuals' incomes increase to compensate, pushing them into higher marginal tax brackets.
40. Inflation sees taxpayers' nominal-incomes, but not real-incomes, increase. Because income tax thresholds are fixed, taxpayers face a higher proportion of their income lost to income tax, without any corresponding increase to their real income.
41. Similarly, average increases in income have the same effect: over time the average tax rate increases for every cohort.
42. We believe the current approach is dishonest - it's an underarm bowl by politicians to hike taxes without having to legislate for doing so. If the Government wishes to increase taxes, it should be forced to pass legislation in Parliament, with public consultation.
43. We note that the costs of bracket creep have been significant, even in the recent low inflation environment. If inflation increases in the future, the costs of bracket creep to households will be much larger.
44. In our 2017 report, *Five Options for Tax Relief*³, we highlighted the cost of fiscal drag/bracket creep on four 'example taxpayers':
 - (a) an 'average worker' earning \$57,000;
 - (b) a family with two children with parents earning \$70,000 and \$30,000 respectively;
 - (c) a low income working earning \$35,000; and
 - (d) A professional earning \$120,000.
45. As the table below illustrates, the average income earner is paying close to \$10 extra per week, or \$480 per year, because the Government did not adjust tax thresholds to allow for inflation since 2010. These inflationary costs are even more significant for our couple and our professional, who lose \$551 and \$628 a year, respectively.

³ A copy is attached.

	Annual Tax Paid			Weekly Tax Paid			
	Current	Fiscal Drag Adjusted	Annual Effect	Current	Fiscal Drag Adjusted	Weekly Effect	% Of Earnings
Average Earner	\$10,120	\$9,637	\$483	\$194.62	\$185.33	\$9.29	0.8%
Couple	\$18,290	\$17,739	\$551	\$351.73	\$341.13	\$10.60	0.6%
Low Income	\$5,145	\$5,077	\$68	\$98.94	\$97.63	\$1.31	0.2%
Professional	\$30,520	\$29,892	\$628	\$586.92	\$574.85	\$12.08	0.5%

46. Ideally, the Government should go beyond indexing to inflation, and income tax thresholds should be adjusted to the growth in average earnings. This would have the effect of keeping the marginal and average tax rates faced by average income earners constant over time. No income earner who has experienced a growth in incomes equivalent to average wage growth will be pushed into a higher tax bracket.
47. Additionally, those income earners who do not see their wages grow relative to the average wage will be fairly compensated with lower average tax rates.
48. The savings this policy would create for New Zealand households are significant. As shown below, if thresholds had been indexed annually since 2010, our average income earner would now pay \$1,361 a year less in tax; our professional \$2,186 a year; our couple \$1,916 a year; and our low-income earner \$236 a year.

	Annual Tax Paid			Weekly Tax Paid			
	Current	Average Earnings Adjusted	Annual Effect	Current	Average Earnings Adjusted	Weekly Effect	% Of Earnings
Average Earner	\$10,120	\$8,759	\$1,361	\$194.62	\$168.44	\$26.17	2.4%
Couple	\$18,290	\$16,374	\$1,916	\$351.73	\$314.88	\$36.85	1.9%
Low Income	\$5,145	\$4,909	\$236	\$98.94	\$94.40	\$4.54	0.7%
Professional	\$30,520	\$28,334	\$2,186	\$586.92	\$544.88	\$42.04	1.8%

49. Fiscal drag has a regressive effect. As middle- and low-income earners have their nominal incomes increase through inflation, they are pushed into higher brackets. However, those already earning above the top threshold cannot be pushed into any higher bracket. The tax system effectively 'flattens', with those on lower and middle incomes pushed into higher marginal tax brackets through time.
50. Indexing income tax thresholds to inflation would ensure households do not have their tax obligations increase year-on-year purely because of inflation. That would ensure that unless the Government chose to pass legislation to increase taxes, the average rate of income tax to households would be consistent over time.

51. In addition to being fair, income tax indexation should be attractive to a centre-left government for political reasons: it avoids centre-right parties being able to offer 'tax cuts' which are illusionary i.e. no more than make up for fiscal drag.⁴ Adjusting for inflation would require politicians offering true tax relief to identify cuts in services.
52. Finally, income tax threshold indexation is consistent with the Government's objective to keep tax revenue at 30% of GDP over the long term.

We recommend legislating annual income tax threshold adjustments indexed to changes in average earnings, or, at minimum, inflation.

Experience in Canada: No taxation without indexation

53. In the mid-1980s the cash-strapped Mulroney Government of Canada (a Government led by the Progressive Conservative Party Government⁵) de-indexed personal credits and tax brackets. That saw government tax revenues increase over time from 1986, without having the political difficulty of having to raise income tax rates.
54. It became a left-right issue. In 1999 a study authored by Ken Battle of the left-leaning Caledon Institute called bracket creep an "insidious virus" that had "pulled more than a million low-wage workers into the income tax net, pushed 1.9 million taxpayers from the bottom to the middle tax bracket and 600,000 taxpayers from the middle to the top bracket" and that ""eliminating bracket creep is good fiscal policy and good social policy."⁶
55. The Liberals⁷ under the leadership of Prime Minister Chrétien, reintroduced indexation as part of the 2000 budget⁸, and it remains in place.⁹
56. We would be happy to provide the Working Group, or its support staff, with further information in relation to the workings of Canada's federal income tax indexation model.

Company taxation

57. New Zealand has very high corporate taxation compared to our international competitors. As a percentage of GDP, corporate income tax revenue was the highest of any OECD country in 2015. Since 1992, corporate tax as a share of GDP has exceeded the OECD average every year.

⁴ Indeed, this is effectively what the Budget 2017 tax relief package was.

⁵ Now the Conservative Party of Canada.

⁶ Lanigan (2015) *Fighting for taxpayers; battles fought & battles ahead*. Canadian Taxpayers' Federation La Fédération canadienne des contribuables

⁷ Canada's main party of the centre-left.

⁸ Plamondon (2017) *The Shawinigan Fox: How Jean Chrétien Defied the Elites and Reshaped Canada*

⁹ We note Prime Minister Trudeau's proposed tax reform measures do not include abolishing the indexation feature.

58. The result of high corporate taxation is a low-investment, low-productivity economy. The OECD noted in their 2017 Economic Survey of New Zealand¹⁰:

“A higher cost of capital than in most other advanced economies contributes to low capital investment. Also, owing in part to its small size, New Zealand has thin venture capital, stock and bond markets.”

“Low rates of capital investment depress wages, with negative consequences for income distribution and inclusiveness.”

59. New Zealand’s low productivity levels have been in the spotlight for the last decade. In 2008, the Government commissioned an investigation into how the per capita income levels could catch up to Australia by 2025.
60. The 2025 Taskforce highlighted low productivity levels and made a series of recommendations, including cuts to corporate taxation¹¹. The recommendations were largely ignored by the Government, and low productivity growth has persisted.
61. The impact of company tax rates on business investment and productivity have been widely discussed. Earlier this year Michael Reddell, former Head of Financial Markets at the Reserve Bank, noted¹²:

“And our company tax rates really matters when firms are thinking about whether or not to invest here at all. And our company tax rates are high, our company tax take is high – and our rates of business investment are low.

“Tax isn’t likely to be the only factor, or probably even the most important – see my other discussions about real interest and exchange rates – but it might be worth the TWG thinking harder as to whether there is not some connection.”

62. In the rest of the world, corporate taxation is trending downwards. The OECD has recently acknowledged that there has been significant downward pressure on corporate tax rates.¹³

Progressive company tax rates

63. Progressive tax rates on corporate income are being specifically floated by the Working Group. The idea is that companies would face staggered income tax rates such that as income increases their marginal tax rate would also increase, with the effect that ‘small’ businesses would face lower tax rates.
64. While the idea of taxing small businesses at a lower rate sounds desirable in purely political terms there are four major issues with the policy.
- (a) Firstly, New Zealand’s dividend imputation system means that for companies that are domestically held, individuals pay their effective marginal tax rate on any dividends. Any

¹⁰ OECD (2017) Economic Survey of New Zealand, Page 35

¹¹ 2025 Taskforce (2009) *Answering the \$64,000 Question: Closing the Income Gap with Australia: First Report and Recommendations*

¹² Reddell (2018) <https://croakingcassandra.com/2018/03/22/so-much-company-tax-so-little-investment/>

¹³ OECD (2017) *Tax Policy Reforms 2017*; OECD (2016) *Tax Policy Reforms 2016*

change in the company tax rate is unlikely to substantially change the tax profile for individuals who rely on company profit streams as their main source of income.

While any retained earnings would be subject to a lower rate, note that companies typically retain earnings when the additional capital is required to grow the organisation and become larger. If any retained earnings fuels capital investment sufficient to push the business into a higher tax bracket, then that capital investment is determined subject to the higher marginal tax rate, not the lower rate.

The result is that for domestic business owners, lower marginal corporate tax rates may not induce additional income streams or encourage greater capital investment from retained earnings.

- (b) Secondly, while international investors do not receive the benefits of dividend imputation and would therefore benefit from lower corporate taxes, it's unlikely that international capital is flowing into small businesses.

International investment is subject to transaction costs (legal costs, language and communication costs, foreign exchange costs) and in the presence of non-zero fixed transaction costs, foreign investment in larger companies makes more sense than smaller companies. To the extent that international investors might purchase smaller companies, growing those companies quickly is typically the aim.

The data indicates this is true. Only two percent of firms have foreign investment, while 47 percent of firms with more than 100 employees have foreign investment.¹⁴ Employment growth is also stronger in firms with foreign investment compared to domestically held companies.¹⁵

The result is that international investors (who, unlike domestic investors do not receive the benefits of imputation and therefore fully pay corporate tax) are unlikely to significantly increase their New Zealand holdings in the presence of lower corporate taxation for small businesses because international investment in small firms is fundamentally undesirable.

To the extent that international investors do invest capital into small business, if the goal is to grow those businesses then the investment decisions are subject to the prospective corporate tax rate, not the rate the business faces at its pre-purchase size.

- (c) Thirdly, if for reasons of revenue neutrality, larger businesses are subject to a higher rate of corporate tax, then we should expect to see less economic growth.

As demonstrated earlier, international investors prefer investing in larger firms. Placing a higher rate of tax on those investments would reduce firms' international

¹⁴ Doan (2012) *Industry Destinations of Inward Foreign Direct Investment in New Zealand*, MBIE Economic Development Group

¹⁵ Fabling, Richard and Sanderson (2013) *Foreign acquisition and the performance of New Zealand firms*, New Zealand Economic Papers

attractiveness (and exposure) and undermine growth. Firms with foreign investment tend to be more productive and pay higher wages¹⁶.

65. Finally, the existing look-through company structure already provide the benefits a two-tier company tax mechanism.

We recommend that if the Government is interested in encouraging greater investment and growth in our productive sector, it should cut the headline business rate, rather than cutting rates just for smaller businesses

Company tax cuts: international literature suggests wage earners benefit most

66. Low productivity growth has contributed to low income levels compared other countries otherwise similar to New Zealand. If the Government is able to improve productivity growth, the result would be higher income levels, reducing financial pressure on households and social services.
67. Cutting corporate taxes, would make New Zealand a more attractive destination for foreign investment. Projects and investments which previously looked undesirable with a 28 percent tax-rate would become economic when subject to a lower rate. The result would be greater foreign direct investment.
68. That's desirable because greater access to capital lifts productivity levels and therefore grows incomes across the economy. Hassett and Mathur (2006)¹⁷ find that *"a one per cent increase in Corporation Tax rates is associated with a nearly one per cent drop in wage rates."*
69. Additionally, as previously noted, exposure to foreign investor pressures drives firms to become more productive than organisations with purely domestic shareholding accountability.
70. It is also important to note the global trend of falling company tax rates. By failing to cut our headline corporate tax rate, we won't just fail to become more competitive, but may actually become less competitive over time as investors channel projects into jurisdictions which are friendlier to investors.

Full expensing of capital investment: the best idea in tax no one's heard of

71. We recognise that the Working Group may be reluctant to substantially decouple New Zealand's company tax rate with the top personal income tax rate.
72. We submit that there are other ways to lower the effective tax rate on companies and achieve the economic gains, without creating the incentives for individual taxpayers to allocate income into a corporate structure to benefit from a lower company rate.

¹⁶ Treasury (2015) *International Investment for Growth*

¹⁷ Hassett and Mathur (2006) *Taxes and Wages*, American Enterprise Institute

73. The most obvious way to do this is to allow full capital expensing. This would increase incentives for business to invest in capital (accelerating productivity growth) and increase wages (productivity growth being the most relevant factor in determining income growth).
74. Full capital expensing was one of the major components of the recent United States tax reform legislation where many businesses can now fully expense some purchases of equipment and capital investment in the year of purchase.
75. The literature indicates that full expensing of capital investment encourages businesses to bring forward planned investment as a result of receiving a tax advantage with substantial evidence indicating that full expensing of capital spending encourages businesses to bring forward investment.
- (a) Ohrn¹⁸ finds that adoption of 100 percent bonus depreciation increased investment activity by 17.5%, and over a five-year period, increased employment by 7.7%.
- “These results suggest that accelerated depreciation policies had and will continue to have substantial impacts on the U.S. manufacturing sector.”*
- (b) Maffini et al.¹⁹ find that firms eligible for first-year depreciation allowances have an 11% increased rate of investment.
76. The fiscal impact is largely temporal. Full expensing pulls forward any existing tax benefits into a single year, rather than increasing the total value of any tax benefits.
77. The effect is that the Government simply delays some tax revenue to the future, and forgoes a small level of interest of the value of the delayed revenue.

We submit that the Working Group recommend full capital expensing to increase incentives for business to invest in capital, productivity and increase wages.

Thin Capitalisation rules

78. In order to maintain revenue flows, there have been a series of recent changes to how foreign investors can use debt to fund ventures in New Zealand. Using debt rather than equity can give foreign investors a tax advantage because interest payments (unlike dividends paid to holders of equity) are tax deductible.
79. Reducing the degree to which foreign investors can fund their New Zealand investments with debt has the effect of increasing investors’ tax-adjusted cost of capital, which makes investing in New Zealand look less attractive.

¹⁸ Ohrn (2017) *The Effect of Tax Incentives on U.S. Manufacturing: Evidence from State Accelerated Depreciation Policies*

¹⁹ Maffini et al. (2016) *The impact of investment incentives: evidence from UK corporation tax returns*

80. Currently, overseas investors can fund their New Zealand-based investments with debt up to 60 percent of the value of gross assets of the venture. Under previous rules, overseas investors were able to fund up to 75 percent of gross assets with debt.
81. Changes being proposed include caps to interest rates on loans between non-resident investors and their New Zealand operations and changes to the eligibility of liabilities for the purpose of calculating the relevant debt ratio.
82. Increasing tax liabilities on foreign investors disincentivises investment into New Zealand for reasons previously discussed in this submission. The Working Group should be careful not to recommend any drastic changes to the thin capitalization rules before any analysis is performed on the costs of reduced investment.

We submit that the Working Group recommend loosen thin capitalisation rules in order to encourage greater foreign investment into New Zealand businesses, growth in the economy and wages.

Businesses owned by charities and Maori Authorities – removing the loopholes

Commercial business deemed ‘tax charitable’

83. Companies owned by charities and Maori Authorities have a tax advantage over their competitors which the Tax Working Group should recommend be closed.
84. Under the current law companies owned by registered charities are liable to pay zero income tax, even if only a portion (or none) of their income is distributed to the parent charity and the business’ activity has no connection to the charitable purpose.
85. We submit that now all businesses are able to deduct for charitable giving up to 100 percent of their taxable income, the blanket exemption applying to commercial organisations owned by charities should be abolished.
86. The competitive advantage that companies owned by charities receive is that they receive a tax exemption on all of their earnings, not just the portion distributed to the charitable cause.
87. There is a risk that charities may reinvest any distributed earnings from the companies they own and therefore avoid their tax obligations. However, rules can be created to net any capital contributions from the parent charity across the tax year, and therefore avoid these concerns.

We submit that companies owned by charities should only be allowed to have the charitable tax deduction to the extent of companies profits actually distributed back to the parent charity, or specifically applied to the charitable purpose of the parent.

Race-based tax: Maori Authorisation

88. Maori Authorities are liable to pay 17.5% income tax, rather than the usual 28%.
89. The effect of these loopholes is that some companies (for example, Sanitarium and GoBus) are able to:
 - (a) build large cash reserves from either un-taxed or under-taxed reinvested income streams, giving them competitive advantages over other firms in their sector; and
 - (b) face a lower cost of capital, and therefore maintain uncompetitive prices, that other firms (who don't receive the same regulatory benefit) cannot match.
90. Closing the loopholes would ensure a more competitive environment in the sectors where these companies operate. Every firm would be subject to the same regulatory burden, ensuring they face similar costs of capital.
91. The advantage that Maori Authorities receive is fundamentally arbitrary. No business should receive a competitive advantage on the basis of blood or race.

We submit that the 17.5% income tax rate for Maori Authorities should be abolished – so that Maori Authorities are not provided with a cash flow advantage over non-Maori competitors.

Section Three: Capital taxation

92. The tax treatment of capital is raised regularly in the media, primarily by people who are concerned that wage earners pay a disproportionate level of tax compared to the owners of capital.
93. The most prominent policy proposal in this space has been a capital gains tax, although smaller political parties have proposed alternative forms of capital taxation.
94. The Working Group has been tasked with investigating the introduction of a capital gains tax.
95. This submission will consider capital taxation as a broader issue across a variety of methods of capital taxation.
96. We submit that taxing capital should be approached with great caution in the specific New Zealand context. As addressed earlier, New Zealand's economy suffers from shallow capital markets and low productivity, contributing towards a low wage environment. A capital gains tax would likely make that worse.
97. While a redistribution of tax burden from capital owners to income earners would have an income improving effect for low wage earners in the first order, there is a danger in disincentivising the capital accumulation which will be required to sustainably improve wages over the long run.

Why tax capital?

98. In *Capital*, *Piketty* argues that capital has a tendency to snowball. As a result, the owners of capital would find their net asset position accelerate through time, with the effect of growing inequality.
99. Notwithstanding the public perceptions and political claims, historical data indicates income inequality has not grown in New Zealand since the early 1990s²⁰. Most of the variation over the period has been a product of housing-related costs.
100. Capital taxation proponents argue that effective taxation can limit inequality, while providing revenue for state services.
101. To the extent that we view inequality as undesirable, tax system changes that provide an improvement in wealth distribution with zero cost in economic growth might be effective public policy.
102. However almost all policies that seek to address inequality impose economic distortions that would damage economic growth.

²⁰ Creedy, Gemmill and Nguyen (2017) *Income Inequality in New Zealand, 1935 – 2014*, Victoria University of Wellington - Public Finance Working Paper 07/2017

103. To determine whether reducing inequality would be desirable, we need to firstly consider how combatting inequality might impact economic growth, and whether that trade-off would be acceptable.

Inequality as a justification

104. Inequality measures the gap in income or wealth between strata in society. Those in favour of reducing inequality often use the lens of poverty reduction, but this is incorrect.
105. While inequality is often associated with poverty, improvements in absolute levels of poverty over time are not always associated with reductions in inequality.
106. In fact, as economies grow and individuals are pulled out of poverty, inequality often increases as a product of greater profit streams to investors.
107. Moving to other justifications, those in favour of reducing inequality often argue that inequality promotes societal divisions and reduces individuals' faith in public institutions.
108. While there might be some benefits in reduced inequality if that was the result of increases in incomes of all households through time (a "pareto" improvement), this is not the typical public policy approach.
109. Public policies to address inequality typically transfer income from wealthier households to poorer households, which because it makes some households worse off, does not represent a 'pareto' improvement in wellbeing.
110. These policies tend to have second order effects (economic distortions, or 'deadweight losses') that manifest as dampened growth and therefore comparatively lower wages for all earners through time.
111. Wilkinson and Pickett²¹ makes the case for reducing inequality in order to foster improved social outcomes in *The Spirit Level*. They claim that inequality is a major factor in determining life expectancy and health outcomes, crime rates, and educational outcomes.
112. However, many of the claims made by the authors are attributable to unjustified data selection and cherry picking. Their conclusions are strongly rebutted by Sanandaji et al. (2010).²²
113. To the extent that inequality doesn't create negative social outcomes, tax changes shouldn't be assessed through the lens of effects on income inequality, but rather their impacts on income strata in absolute terms.
114. Incomes at all levels are a result of productivity growth and the labour share of national income. According to the *Productivity Commission*, the labour share of national income hasn't experienced a significant decline, even in the presence of structural changes to the tax system over the last 35 years.

²¹ Wilkinson and Pickett (2009) *The Spirit Level*

²² Sanandaji et al. (2010) *The Spirit Illusion*

115. To the extent that tax changes don't impact the labour share of national income, the appropriate lens for examining the effect of tax changes on incomes is productivity growth.
116. Based on that, this submission will therefore specifically consider how proposed capital tax changes impact the determinants of productivity, alongside any financial impacts on households.

Capital gains tax

Summary

117. Explicit capital gains taxes are typically justified as a mechanism to make the tax system more progressive. Those who own assets subject to capital gains taxes tend to be wealthier, so using any revenue gained to cut other taxes or increase spending would have the effect of reducing inequality levels.
118. But as explained above, inequality should not be the primary lens for examining substantive tax changes and we will therefore consider the effects of a capital gains tax on economic growth and any flow on financial impacts on households.
119. Capital gains taxes can either be imposed on realised gains or accrual gains. In summary, the former would impose significant productivity costs, while the latter would be administratively burdensome, and a dishonest rebuke of existing principles of tax.
120. Additionally, we believe the Working Group cannot reasonably recommend a capital gains tax, given the required primary residence exclusion.

Primary Residence Exclusion

121. The terms of reference require the Working Group to exclude the family home (and land under) from proposed new taxes.
122. The exclusion of the family home would materially distort any proposed capital gains tax. Any capital gain in the primary residence would be untaxed, compared to other capital gains. That provides a comparative incentive to invest in the primary residence rather than other kinds of investment.
123. That would have two undesirable effects:
 - (a) Firstly, it encourages households to invest disproportionate amounts of capital into their primary residence. The result would be larger and more grandiose homes with reduced investment in rental properties.
 - (b) The result of reduced rental property supply would be increased financial pressure for renters. While the data is still unclear on this effect, Coleman has shown that the effect of a capital gains tax would, in general, increase rents.²³

²³ Coleman (2009) *The long term effects of capital gains taxes in New Zealand*, Motu Working Paper 09-13

- (c) Secondly, tax-distorted investment into primary residences would have the effect of pushing up house prices, which may reduce the ability of first-home-buyers to purchase their first house.

124. In summary, if the objective is to increase the affordability of home ownership introducing taxes on all other capital investment except the family - and thereby creating a tax incentive for New Zealanders to stash money in housing - is the very last thing which should be recommended.

Investment Effects

125. Imposing a capital gains tax also discourages investment in companies which tend to deliver value to shareholders by improving their capital value, rather than distributing consistent dividends early in the organisation's growth cycle.

126. Those companies tend to be tech focused, or more generally, tend to have a thirst for capital. Imposing a capital gains tax would disincentivise investment in these kinds of companies compared to those that pay a reliable dividend.

127. Capital-reallocation requires a liquidation of an investor's position. Any gain in asset value over the period it has been owned would be taxed. Effectively, capital re-allocation is now subject to transaction costs as a proportion of the previous success of the stock.

128. That disincentivises re-allocation of capital to more productive investments, reducing investor returns and economic growth. This is described in the literature as the 'lock-in' effect.²⁴

Accrual or realisation?

129. One of the key issues that the Working Group will need to grapple with, if it chooses to recommend a capital gains tax, is whether it should recommend the tax based on accrual capital gains or a tax at the time of capital gain realisation.

130. Using an accrual system largely removes the problems associated with a lock-in effect. Tax would be owed whether an investor liquidated their position or not, and therefore there exists no disincentive for the reallocation of capital from investments which are expected to be low yield through to investments which are expected to have a higher yield.

131. An accrual-based capital gains tax would also provide capital loss credits to investors in the event of a decline in asset price values even if investors wanted to hold their positions, rather than liquidate their investments.

132. Any capital gains tax provides a level of counter-cyclical smoothing; however, an accrual capital gains tax more fully smooths investor positions for the reasons illustrated above.

133. However, accrual capital gains taxes are much more complex to administer than realisation taxes. Tracking capital valuations over the financial year, often pro-rata, is viewed by many as more complicated than the simple change in value of an asset from when it is bought to when it is sold.

²⁴ Burman and White (2009) *Taxing Capital Gains in New Zealand: Assessment and Recommendations*

134. While the value of publicly traded assets (stocks and bonds, for example) is easy to measure across the tax year, private equity and housing, given the lack of information on a market price in absence of sale, is more difficult to assess.
135. Some difficulty would stem from individuals having an incentive to underrepresent the true value of their assets. The result would be an ineffective system where significant resources would be required to monitor households and audit a selection of taxpayers in order to provide accountability to the system.
136. One solution would be for IRD to set up a regime where investors would have the right to buy any asset reported to the state at its listed price. Individuals then have a strong incentive to report assets at a fair valuation so that any purchase at that price would not leave them materially worse off.
137. While that would offer an efficient solution to price assessment, it would likely be extremely unpopular. People often have emotional attachments to their assets (their family home, an expensive heirloom, a boat or car) and are unlikely to view a policy that allows the State to facilitate other people seizing those assets, even with financial compensation, favourably.
138. We consider accrual capital gains taxes are not honest and transparent, as defined in section one. Until an asset is liquidated, the owner has not earned any income for any appreciation in value. Punishing taxpayers for holding on to art they may have inherited, or a family home they have lived in for many years should not be part of the tax system.

Sustainable revenue base: Capital gains taxes perform poorly

139. Finally, we note that one of the reasons the New Zealand Crown accounts got through the Global Financial Crisis so well, particularly in comparison to Australia, is that our Government's tax revenues are far less tied to asset prices. To borrow finance's measure of volatility, the beta of capital gains taxes is much higher, and makes the tax system more vulnerable to shocks.

Land tax

140. Land taxes have been floated as an option to broaden the base of tax revenue.
141. Taxes on the unimproved value of land impose very few economic distortions. As land has a fixed supply and land taxes do not scale with improvements, there would be no disincentive effect on land improvements or capital investment on land.
142. That is an important benefit of land taxes: almost all forms of taxation have distortionary economic effects. Using revenue streams that don't distort economic outcomes in order to fund cuts to distortionary taxes would be a useful tool to improve productivity growth.
143. Some sectors of society would be hurt more than others from the imposition of a land tax. Coleman and Grimes²⁵ (2009) note the distributional impacts of land taxes. Households and industry sectors that own disproportionate amounts of land relative to their income (for

²⁵ Coleman and Grimes (2009) *Fiscal, Distributional and Efficiency Impacts of Land and Property Taxes*, Motu Working Paper 09-14

example, retirees, agriculture, forestry) would suffer more from the tax than other groups. Land owners facing constraints on the use of land, such as heritage buildings, are also potentially unfairly hit. Nevertheless, so long as the tax base (land valuation) is measured with an understanding that the land cannot be developed in certain ways so has reduced economic value, we believe those concerns can be addressed.

144. In general, while those purchasing land after the tax wouldn't be any worse off as a result of the tax (land prices would adjust by the present value of future tax liabilities), current holders of land would be hit both by:
 - (a) future tax liabilities; and
 - (b) a fall in the value of their land equal to the present value of future tax liabilities.
145. In a technical sense, the economic value of the tax can be treated as a one-off transfer of wealth from current land owners to the Crown. This is likely to cause some short-term negative economic consequences, in particular:
 - (a) for highly leveraged households and businesses, a fall in the value of their land pushes them into a position of negative equity; and
 - (b) transferring substantial quantities of wealth from the private to the public sector may result in a short term economic downturn as households feel poorer and adjust their spending patterns for a period of time.
146. While that might prove politically unpopular among existing land-owners, using the revenue gains to fund cuts to distortionary taxes would have the effect of lifting incomes through time.
147. In our view, a land tax should be implemented, with the proceeds used to fund cuts to distortionary taxes, like company taxation and taxation on savings. However, the Terms of Reference specifically exclude any tax imposed on an individual's primary residence, including the land on which their house sits. This imposes an artificial distortion on any proposed land tax, undermining the useful non-distortionary attributes of land taxes. Without further work, it is difficult to assess whether a land tax excluding residential property (and possibly other classes of land) would have more economically distortionary effects than it would solve, even if the revenue was used to reduce other taxes.

We submit that the Working Group note in its report that had they not been constrained by the primary residence exclusion, then they would have recommended a land tax to the Government with all proceeds used to reduce more economically damaging taxes, such as that on income.

Imputed income taxation

148. If the Working Group wants to broaden the base by taxing capital, an alternative to a capital gains tax would be a tax on the imputed income of home-owner equity.

149. Some economists claim that owner-occupied homes provide a form of income to the owner equivalent to the amount of rent they would otherwise be required to pay to live in that home and that this 'imputed income' is not currently taxed.
150. Submitters have been asked to specifically consider how the tax system impacts housing affordability. The current failure to appropriately tax home-owner equity imposes a distortion in the housing market leading homes to become more opulent and less affordable.
151. If the Government wanted to take housing affordability seriously, they shouldn't have imposed the primary residence exclusion. The current favourable tax treatment of owner-occupied property exacerbates the problem of housing affordability.
152. While this is not an option available to the Working Group as a formal recommendation to the Government (given the primary residence exclusion), but it should nevertheless be included in the Group's reports.
153. Not taxing imputed income imposes a distortion on the tax system, encouraging individuals to invest disproportionate levels of capital into the home in which they live²⁶.
154. Coleman notes that this may have contributed to a trend of ever-increasing house size, although the data is still unclear²⁷. Incentivizing larger and more opulent homes distorts home quality distribution.
155. This policy was advanced by the Opportunities Party²⁸ at the most recent election. The Party's argument was that capital taxation can be used to fund income tax cuts, and therefore shift the national tax burden from income earners to home owners on the margins.
156. Increased capital taxation to fund income tax cuts would likely have a progressive distributional effect: those who earn income but do not have high levels of equity would receive a tax advantage.
157. Funding cuts to more distortionary taxes would also be productivity growth improving, which would then fuel income growth through time, as demonstrated earlier in our submission.
158. Much of this effect would be temporal: young people tend to have few assets compared to their income level and so would receive an advantage from moving to this system of taxation, whereas the retired elderly tend to have very little income compared to the value of their assets.

We submit that the Working Group should not recommend a capital gains tax. A capital gains tax would hurt productivity growth and discourage

²⁶Page 40 of the Paper demonstrates the different rates of marginal taxation on savings, and correctly notes that home owner equity is taxed at a much lower rate than other forms of savings.

²⁷ Coleman (2017) *Housing, the 'Great Income Tax Experiment', and the intergenerational consequences of the lease* Motu Working Paper 17-09

²⁸ Available at <https://www.top.org.nz/top1>

investment, without providing a secure revenue stream to the Government.

We submit that the Working Group's Terms of Reference mean that it cannot recommend a comprehensive capital gains tax, due to the distortionary effect this would have in worsening housing affordability. If the Working Group does not accept this submission, we submit that in preference to an Australian-style complex capital gains tax, a comprehensive land tax, or failing that, a tax on the imputed income of home-owner equity, is preferable.

Section four: Taxes on savings and investments for retirement

159. When savings earn interest income, that interest income is taxed at the individual's marginal income tax rate. The tax is applied to the nominal interest income (which includes inflation) rather than their after-inflation real interest income.
160. The result is that the effective marginal tax rate on interest income is much higher than the headline statutory rate. The size of the tax distortion depends on the rate of inflation. As inflation creeps higher, the tax adjusted real return on savings falls. This has two effects:
- (a) those saving for retirement are required to commit a higher proportion of their income to their savings in order to ensure a comfortable standard of living when they retire; and,
 - (b) a significant contribution to New Zealand's low savings rate. When domestic savings are insufficient to fund investment, we borrow from abroad which increases our international debt exposure.
161. We submit that the Working Group should recommend an inflation exemption for interest income, so that only the real return to savers is taxed.
162. This change would significantly increase the returns of long term savers. For example, an individual who put \$10,000 into a savings account with a nominal interest rate of 5.5 percent per annum, of which 2 percentage points is inflation
- (a) Over a period of ten years, if the Government chose not to tax the inflation component of any interest earned, that individual would have approximately \$900 more in savings than had the Government taxed the full amount of nominal interest.
 - (b) That represents a 22% increase on the saver's ten-year return.
 - (c) As inflation increases, the distortionary effect of taxing the inflation component of nominal interest income increases. Holding all other variables constant, increasing inflation to 4% would increase the difference in returns to a saver to 35.5% under the two alternative tax treatments.
163. If an individual is saving regularly for the retirement over a very long period of time, there is an even larger difference. For example, an individual who saves \$10,000 a year, for 40 years, deposited monthly into a savings account. As above, they earn a nominal interest rate of 5.5 percent per annum, of which 2 percentage points.
- (a) After the 40-year period, the individual taxed only on their real return has approximately \$1,079,000, while an individual taxed on their nominal return has \$165,000 less – only \$914,000. That's equivalent to a 18% difference in retirement savings after 40 years.
 - (b) If inflation is higher at 4% over the same savings period, then the individual taxed on their real returns is better off by 42.6%.

164. Taxing nominal returns can have a significant impact on long-term savings. Given that many retirees depend on long-term savings to live on when they retire, a move to taxing only real returns would improve the wellbeing of many retirees.
165. Reducing taxes on long-term savings also helps working families before they retire, as better post-tax returns mean households are able to save less while maintaining the same level of long-run savings. Families with tight budgets would have more room to meet their financial needs while continuing to save enough for a comfortable retirement.
166. The net result of this change in the tax treatment of savings is a higher domestic savings rate. Higher domestic savings rates driven by tax cuts would have the effect of lifting long-run living standards.
167. Despite typical economic models not showing increased domestic savings levels in a small open economy driving significant increases in investment²⁹ a Treasury review of international evidence in 2011³⁰ found that increased domestic savings levels would put some downward pressure on real interest rates, leading to increased levels of investment, driving economic growth.
168. Additionally, a 2012 review of possible tax changes by Inland Revenue and Treasury³¹ found that reducing the tax on interest income would lift savings rates and provide modest increases to GDP.
169. Further, increases in domestic savings results in less international finance being required to fund domestic investment. That would have the effect of putting downward pressure on the foreign exchange rate and increasing net exports.
170. The Treasury review mentioned above indicates there is substantial evidence for productivity-enhancing growth and innovation as a product of increased export levels. As industries become more successful exporting internationally, there are knowledge and supply-chain development spillover effects which flow through to other businesses and sectors.
171. Additionally, as we reduce our international debt exposure, interest payments overseas will fall, leading to an effective improvement in domestic income levels.
172. The net effect of these changes according to Treasury “would most likely permanently lift MFP growth rates.” The result of higher productivity growth would be higher income growth through time.

We submit that the Working Group recommend that savers should only pay tax on their real interest income – inflation doesn't make savers better off so it should not be taxed

²⁹ Claus et al. (2001) *Saving and growth in an open economy*

³⁰ Treasury (2011) *Will higher national saving lead to higher GDP growth or income levels in New Zealand? A review of the literature*

³¹ Inland Revenue and Treasury (2012) *Taxation of Savings and Investment Income*

Section five: Environmental taxes

173. The Working Group is investigating the effects of additional environmental taxes. The specific concerns focus on water quality and greenhouse gas emissions.
174. While reduced climate change and improved water quality would improve the wellbeing of a large number of people, policies designed to combat these problems are accompanied by significant economic costs, particularly for rural areas.
175. We submit that any proposed environmental taxes should come with recommendations which make them revenue neutral.
176. Revenue neutrality would limit the scope of economic harm from any environmental taxation, although there would still be significant distributional impact on rural areas. If environmental taxes were accompanied with cuts to other distortionary taxes, there would likely be a shift in economic output from rural to urban areas.
177. While there are significant social and economic costs associated with climate change, the degree to which New Zealand is able to make a meaningful impact may be limited. Climate change is a globally determined phenomenon, and while domestic changes may make a small impact, the cost of doing so would rest solely on the domestic economy.
178. There are other good reasons to engage in efforts to combat climate change (purely moral considerations, or concerns for international political capital), but it should be acknowledged that the economic case suffers from international collective action problems manifesting as reduced welfare for New Zealand residents (both today and into the future).

We submit that any new environmental tax or water tax proposal should be subject to disciplined and transparent cost-benefit analysis.

Economic impact

179. Agriculture is exposed to risks distinct from other sectors. While water pricing and emissions pricing would damage urban commerce to some degree, the agricultural sector could face widespread financial damage.

Water taxation

180. Water taxes have been proposed as a tool to reduce farming intensification and improve water quality. The aim of the policy is to impose a per/litre price on the use of water, particularly for irrigation purposes and bottling for sale. Our submission will focus on the impact of a water tax on irrigation.
181. Proponents of water taxes are concerned that the intensification of dairy farming coupled with widespread irrigation use is harming the water quality of rivers, lakes and streams.

182. Irrigation can increase the scope of harms to river quality from the use of nitrogen and phosphorous based fertiliser³².
183. While improved water quality would have some impact on wellbeing, the Working Group should carefully consider the economic consequences of reducing the scope of irrigation in rural areas.
184. The agricultural sector heavily relies on irrigation to ensure otherwise dry land is productive.
- (a) A paper published by NZIER and AgFirst in November 2014³³ indicated that the total value of irrigation was approximately 2.4% of GDP, or \$4.8 billion in total output per annum. The same report finds that 71.3% (\$1.39 billion) of net farm gate value in Canterbury can be attributed solely to irrigation.
 - (b) The effect of a water tax would be to reduce the scope of irrigation and dampen productivity of farm land. While advocates for water taxation have tried to downplay the financial effect of any proposed tax, it should be acknowledged that the tax would only achieve improved environmental outcomes to the extent that it reduced the scope of irrigation.
 - (c) More productive arable land provides greater opportunities for on-farm employment and off-farm employment in adjacent service towns and communities. Correspondingly, reducing agricultural productivity would have negative flow on effects for regional communities.
185. Given any tax reform should be revenue neutral, many of the economic costs from a water tax would be recouped across the broader economy.
- (a) Lower personal income taxes and/or lower corporate taxes to make up for a water tax may cause a net substitutive effect from rural areas to urban areas but comparing the economic costs of reduced irrigation to the any economic benefits from tax cuts in other areas is complicated.
 - (b) Given the complicated nature of these trade-offs, as expressed earlier, any proposed water tax should be subject to a formal cost-benefit analysis.
186. We were concerned to see during the election campaign water tax proposals focusing on specific uses of water, or industries. For example, taxing water bottling appears to us unjustified, where other often more damaging uses (such as intensive dairy farming) use much more, for less economic gain to New Zealand.

We submit that any taxes on water should operate in a similar way to water rights pricing and be sector neutral – politicians should refrain from

³² Ministry for the Environment (2017) *Our Fresh Water 2017*

³³ NZIER & AgFirst (2014) *Value of Irrigation in New Zealand*

Emissions taxation

187. In relation to emissions taxation, we submit that policies should be able to demonstrate genuine reductions in world emissions, and/or increases in productivity (in terms of output per emissions unit). New Zealand should avoid imposing economic costs on itself, if emissions are simply going to be exported and any environment gain lost.
188. The agricultural sector produces significant methane emissions, which contributes towards climate change. Climate change policy experts typically advocate for either bringing agricultural emissions into the emissions trading scheme or introducing a specific emissions tax for methane.
189. Emissions taxation is only effective if it reduces the scope of domestic agricultural emissions. This could be achieved in two ways, each of which would impose significant costs on the agricultural sector:
- (a) Firstly, to the extent that innovation is possible, farmers may investigate breeding programmes, vaccines, and other changes in order to reduce methane emissions without changing their herd size.
 - (b) Secondly, to the extent that innovation isn't available or only available in limited ways farmers may choose to exit the industry or reduce herd size if their profit margins are sufficiently thin.

Households finances

190. The effect of a carbon tax would be to increase fuel costs and therefore transportation costs, both for households and the business sector.
191. Increasing transportation costs would cause regressive economic effects.
- (a) Low socio-economic status households tend to live further out from their workplaces, drive cars which are less fuel efficient, and tend to have a larger number of children.
 - (b) The result is that a relatively higher proportion of their income is spent on fuel, and so a fuel tax would force a relatively higher financial burden on low income families and communities.
192. Transportation costs are a significant factor in determining the total cost of producing goods and services. Increased transportation costs would be transferred through to consumers in the form of higher prices for food, clothing, and other consumer goods.
193. Much of the damage to households could be recovered by reducing income taxation, although for low income households who pay little income tax but also consume most of their income, any tax cuts may fail to sufficiently compensate any losses.

194. In a consultation document published in 2015³⁴, the Ministry for the Environment calculated that the cost to an average household of achieving an emissions target of 5% below 1990 emissions levels would be approximately \$1270 per annum.
195. Imposing costs on low income households may be desirable if there are sufficiently large future welfare gains related to the prevention of climate change. Again though, these costs and benefits should be assessed, and taxes not imposed for moralistic, ideological, or virtuous generalisations.

Benefits of environmental action

196. It is non-trivial that all policies designed to combat climate change would result in welfare improvements for current and/or future generations of New Zealanders.
197. The typical economic justification for imposing emissions taxes is that market transactions fail to account for costs incurred by parties who are external to the transaction. In the instance of emissions, the social cost manifests as climate change induced by the emission of green-house gases. Note that the social costs of greenhouses gases should be attributed globally rather than domestically.
198. New Zealand's emissions make up 0.17% of total global emissions, while the top five emitters contribute 54% of global emissions.
199. Even major reductions in our emissions profile would create very small wellbeing improvements, given wellbeing is determined by global emissions levels.
200. However domestic efforts may not translate into global improvements.
- (a) Imposing emissions costs and sanctions on local industry may shift production to other states with more relaxed environmental regulation.
 - (b) The New Zealand regulatory environment is too small to shift global demand for agricultural products or fuel.
 - (c) The result is that as we reduce domestic production in agriculture and fuel, foreign markets will respond to global demands and expand production.
 - (d) This result (carbon leakage) could significantly reduce the scope of any reductions in global emissions from domestic policy settings.

As an alternative to recommending specific environmental taxes, we submit that the Working Group develop an objective framework for future proposed environmental taxes to be measured against.

³⁴ Ministry for the Environment (2015) *New Zealand's Climate Change Target*

Section six: Behavioural taxes

201. The Working Group has signalled an interest expanding the scope of behavioural taxes. We oppose an expansion of the use of behavioural taxes. They are generally poor in achieving their stated aims and impose significant financial costs on low income households.

We submit the Working Group recommend against the expansion of behavioural taxes, and instead outline the regressive financial damage they inflict on our most vulnerable communities.

202. Specifically:

- (a) We oppose the introduction of a sugar tax, a fat tax, or any other form of additional tax on food products.
- (b) We oppose increases to tobacco excise.

Sugar taxes

203. We submit that the Working Group should recommend against implementing a sugar tax.
204. International evidence shows that sugar taxes (specifically taxes on sugar-sweetened beverages) are not effective in achieving their stated health goals.
205. In 2015, we released a report, *Fizzed Out*, which demonstrated the failure of a sugary drinks tax to reduce consumption levels in Mexico. The Nielsen sales data we released showed that the sugar tax only induced a 0.2% reduction in consumption. A copy of the report is appended to this submission.
206. NZIER prepared a literature review for the Ministry of Health in 2017 which showed that “the evidence that sugar taxes improve health is weak.” The authors clearly articulate the problem in making public policy based on weak evidence in the conclusion of their report

“If taxes did not have economic costs, through deadweight losses and implementation costs, then even a slight causal link between a tax and an improvement in health outcomes might be justified. That, however, is not the case.”

207. Andalon and Gibson (2017)³⁵ found the own-price elasticity of quantity demand for sugar sweetened beverages in Mexico was much lower (-0.2 to -0.3) than had been expected (-1.0 to -1.2) when the Mexican sugar tax was implemented.
- (a) A lower price elasticity of demand implies consumers respond less strongly to the imposed tax, and therefore the tax induces weaker health outcomes than expected.

³⁵ Andalon and Gibson (2017) *The ‘Soda Tax’ is Unlikely to Make Mexicans Lighter*, Institute of Labour Economics

- (b) The authors find that the tax would cause an average weight loss of 400 grams per person.
208. To the extent that sugar taxes don't deliver good health outcomes, we should avoid imposing additional costs on taxpayers, especially low socio-economic status households.
- (a) Consumption taxes tend to be regressive because low socio-economic status families tend to consume a higher proportion of their income compared to wealthier families.
 - (b) Additionally, low socio-economic status families tend to spend a higher proportion of their income on foodstuffs than wealthier families.
 - (c) The result is that sugar taxes put more financial pressure on the families who are least able to afford them.

Tobacco excise

209. We submit that the Working Group should recommend that the Government halts all increases to tobacco excise and instead legalise nicotine fluid for e-cigarettes and other non-smoke alternatives. These technologies provide an alternative for smokers and have far reduced negative health effects.
210. Tobacco excise imposes significant financial burdens on the communities least able to afford tax increases, while failing to achieve its principal goal of reducing smoking prevalence.
211. In our report, *Up in Smoke*, released on 1 January 2018, updated our earlier report, *Passive Income: How the Government users smokers as cash cows*. In the reports we demonstrated the significant social costs of increasing tobacco excise. Copies of both reports are attached to this submission.
- (a) Despite tobacco excise increasing by more than 60% since 2012, only one in ten adult smokers quit. Among Maori and Pasifika there has been no statistically significant change in smoking rates over the last decade.
 - (b) A pack-a-day smoker is worse off by nearly \$3,000 a year in real terms compared to 2010. Given smoking is more prevalent in low socio-economic communities, tobacco excise increases have the effect of hollowing out the budgets of the most vulnerable families.
 - (c) Tobacco excise increases have been associated with significant growth in targeted robberies of dairies and convenience stores.
 - (i) While the Police haven't recorded statistics on any relationship between the targeting of tobacco and burglaries or robberies, robberies in general have increased 26.6% since 2014.
 - (ii) There has been significant media coverage of the relationship between excise increases and robberies, causing the Government to fund security measures for dairy and convenience store owners concerned for their safety.

212. If the sale of e-cigarettes and other alternatives were legalised, addicted smokers would be able to move to an alternative that causes them far reduced negative health effects. Instead, with no alternatives available, addicted smokers suffer under the financial burden of ever-increasing tobacco excise, causing many to rely on the black market.

We submit the Working Group recommend the legalisation of smokeless nicotine alternatives to cigarettes, in preference to continued tobacco tax hikes.

Section seven: Varying GST

213. Just as some groups advocate for increased excise taxes and expanding behavioural taxes to sugar and fat, other groups advocate for removing or reducing GST on some goods and services.

We submit the Working Group should acknowledge that our system of GST is the envy of the world and recommend against any changes to our broadly applied and uniform rate of GST.

214. There is very little justification for changing the nature of GST.
- (a) Our GST system is simple, and easy to collect and administer.
 - (b) While it's appealing to choose to tax 'merit' goods less, and 'demerit' goods more, GST is an inefficient vehicle for enacting market or social changes.
 - (i) Varying GST for different goods would create significant administrative burdens for IRD and businesses.
 - (ii) Removing GST on fruit and vegetables, for example, would require IRD to classify what a fruit or vegetable is ("Are frozen chips vegetables? If not, what about other frozen vegetables?"), then audit businesses according to their classifications.
 - (iii) Businesses who sell goods with different rates of GST would be faced with increased administrative burden in calculating their tax obligations.
 - (iv) Any change in GST classifications over time would force businesses to spend time changing their accounting systems.
 - (c) Eric Crampton of the New Zealand Initiative notes³⁶:

"Under the current beautiful broad-base, low-rate system, companies gather all their receipts for everything they purchased when making things and claim the GST on them. They then charge GST on the full value of their final product. Their net GST is on the value they added to their inputs along the way, since they netted out the GST from the inputs. Nice, clean and easy."

"There are worthy causes innumerable. But if government is to fund them, it is almost always best to do it from general tax revenues. The overall tax system is already designed to balance equity and efficiency – to place the burden where it can most easily be borne."

³⁶ Crampton (2017) *Outside the Asylum*

215. While we don't support them, even direct subsidies of goods and services would be preferable to making changes to our GST system in order to favour some goods and services over others.

Section eight: Tax treatment of cryptocurrencies

216. We submit that IRD guidance on cryptocurrencies needs to be rewritten to reflect the true nature of technology and the Working Group should recommend this. Current IRD guidance incorrectly treats cryptocurrency as property.
217. The Working Group should recommend IRD conduct a review of their current tax guidance.
218. The current tax guidance of cryptocurrency is as follows:
- (a) IRD treats cryptocurrencies as property, not currency, for the purposes of tax.
 - (b) If a business receives payment in a cryptocurrency, it is liable to pay tax on that income stream in equivalent NZD.
 - (c) If an individual has bought cryptocurrency with the intent to dispose at a later date (for example, speculating on future price increases with an expectation of a future sale) then they will be liable to pay tax on any realised capital gain.
219. The major problem is related to how IRD views those who purchase cryptocurrency. IRD assumes that cryptocurrency does not provide benefits outside of its disposal, and therefore treats holders of cryptocurrency as speculators. The specific language is as follows:
- “Bitcoin and similar cryptocurrencies generally don’t produce an income stream or provide any benefits, except when they’re sold or exchanged. This strongly suggests that cryptocurrencies are generally acquired with the purpose to sell or exchange them.”*
220. This is an incorrect interpretation of the use of cryptocurrencies as there are a variety of cryptocurrencies which do either produce income streams or provide other useful benefits.
221. For example, proof-of-stake currencies reward holders of coins with a form of interest. While bitcoin employs a ‘mining’ approach, where the solution of complex computational problems earns ‘miners’ additional coins, some cryptocurrencies simply reward those who hold coins with additional coins, scaled to the number of coins they hold.
222. Cryptocurrencies are increasingly used for purposes other than alternative currency use.
223. Golem³⁷, a cryptocurrency founded in Poland, is a tool for allocating computing power from those who have spare computational capacity, to those who need greater computing power. An individual who purchases coins with the intention of accessing greater computing power for a project should not be assumed to be a speculator.
224. Another cryptocurrency, Augur³⁸ is prediction market software which employs ‘reputation tokens’ (REP, a form of cryptocurrency) in order to authenticate events. An individual who

³⁷ <https://golem.network/>

³⁸ <http://www.augur.net/>

chooses to hold REP in order to authenticate events on Augur prediction markets is not holding REP with speculative intent and should not be taxed as such.

225. We submit that the tax treatment of cryptocurrency should reflect the true nature of each cryptocurrency, rather than a one-treatment-fits-all approach. The tax treatment should be a fair reflection of the use of the assets.
226. A failure to do so may discourage uptake of cryptocurrencies as useful tools in distributed computing, prediction markets, and an array of other instances where blockchain authentication would be valuable.

We submit that the Working Group should recommend IRD guidance on cryptocurrencies be rewritten to reflect the true nature of technology and avoid deeming all cryptocurrency as property.

Thank you for the opportunity to submit.

Yours faithfully,
New Zealand Taxpayers' Union Inc.

[1]

[1]

Jordan Williams
Executive Director

[1]

Joe Ascroft
Economist

[1]

Encl.

Appendix 1: Specific answers to the Paper's "Questions for submitters"

1. The Working Group has asked submitters to specifically answer the following five questions:
 - (a) What does the future of tax look like to you?
 - (b) What is the purpose of tax?
 - (c) Are we taxing the right things?
 - (d) Can tax make housing more affordable?
 - (e) What tax issues matter most to you?
2. We believe we have answered these questions in the main part of our submission, however, we will offer brief, specific remarks below.
3. "What does the future of tax look like to you?"
 - (a) We submit that our tax system needs to be more ambitious. The future of tax is a system where our specific mix of taxes is tailored towards encouraging higher levels of growth and investment.
 - (b) The current system overtaxes corporate earnings and investment. That makes it more difficult for businesses to invest and grow, with then inevitable result that productivity and incomes in New Zealand are much lower than other countries with similar historical experiences.
 - (c) The future of tax includes the following specific submissions to the Working Group:
 - (i) indexation of income tax thresholds to growth in average earnings (or at minimum, inflation);
 - (ii) allowing full expensing of capital investment in the year of purchase;
 - (iii) an end to the favourable tax status of companies owned by charities and Maori Authorities;
 - (iv) no capital gains tax;
 - (v) an inflation tax exemption on interest earnings so that savers are only taxed on their real interest income; and,
 - (vi) an end to tobacco excise increases, and no new lifestyle taxes.
4. "What is the purpose of tax?"

- (a) To raise enough revenue to provide efficient and effective public services, with as few economic distortions as possible.
5. “Are we taxing the right things?”
- (a) Our submission covers the major changes we would like to see to the tax system.
 - (b) We have included these changes in our answer to the first question.
6. “Can tax make housing more affordable?”
- (a) Some tax changes can improve housing affordability, although some tax changes will make it more difficult to buy a house.
 - (b) A capital gains tax would not make housing more affordable – in fact for renters, their cost of housing would likely increase with any form of capital gains tax.
 - (i) Any capital gains tax with a primary residence exemption would distort the housing quality distribution and increase housing costs, as outlined in the main portion of our submission.
 - (ii) We submit that the Working Group should refrain from recommending a capital gains tax. Not only would a capital gains tax worsen housing affordability, but it would damage productivity growth, and therefore income growth for all households.
 - (c) Any tax changes that increase incomes through time will make housing more affordable by lifting the income available to families to buy a house.
 - (d) Tax system changes that undermine future income growth will make it comparatively more difficult for families to enter the housing market.
7. “What tax issues matter to you the most?”
- (a) Firstly, as outlined in our main submission, our tax system should always seek to be as ‘Honest and Transparent’ as possible.
 - (i) Fiscal drag and the inflation tax on savings and investment both have the effect of squeezing more out of the pocket of New Zealanders when they haven’t been made any better off.
 - (ii) This is a dishonest and opaque approach to tax increases. If the Government wants to tax families more, they should have to pass legislation and consult with the public.
 - (b) Secondly, our tax system should seek to be as efficient as possible and impose as few economic distortions as possible.
 - (i) The Working Group should carefully consider our woeful track record in productivity growth when they recommend any changes to the Government.

- (ii) As outlined in our submission, there is plenty of room to make our tax system more efficient and encourage investment and growth.
- (iii) However, many changes being considered would also make our tax system less efficient.
- (iv) Capital gains taxes (especially with a primary residence exclusion), progressive business tax rates, varying rates of GST, and certain forms of environmental taxation all create significant distortions that would further undermine our productivity performance.

Appendix 2: Key submissions

1. We submit that the primary objective of the Working Group should be to recommend changes in the tax system that make it better – i.e. less damaging to the economy, society, and individual liberties; and more efficient.
2. We submit that all changes considered and recommended by the Working Group identify whether they are likely to result in less dead weight loss, fewer economic distortions, and more incentives for economic, wage and income growth.
3. Where new taxes (including reforms to existing taxes which are likely to increase the overall burden of the tax system) are recommended by the Working Group, we submit that the Working Group should identify other areas where the burden can be reduced to compensate taxpayers.
4. We recommend legislating annual income tax threshold adjustments indexed to changes in average earnings, or, at minimum, inflation.
5. We recommend that if the Government is interested in encouraging greater investment and growth in our productive sector, it should cut the headline business rate, rather than cutting rates just for smaller businesses
6. We submit that the Working Group recommend full capital expensing to increase incentives for business to invest in capital, productivity and increase wages.
7. We submit that the Working Group recommend loosen thin capitalisation rules in order to encourage greater foreign investment into New Zealand businesses, growth in the economy and wages.
8. We submit that companies owned by charities should only be allowed to have the charitable tax deduction to the extent of companies profits actually distributed back to the parent charity, or specifically applied to the charitable purpose of the parent.
9. We submit that the 17.5% income tax rate for Maori Authorities should be abolished – so that Maori Authorities are not provided with a cash flow advantage over non-Maori competitors.
10. We submit that the Working Group note in its report that had they not been constrained by the primary residence exclusion, then they would have recommended a land tax to the Government with all proceeds used to reduce more economically damaging taxes, such as that on income.
11. We submit that the Working Group should not recommend a capital gains tax. A capital gains tax would hurt productivity growth and discourage investment, without providing a secure revenue stream to the Government.
12. We submit that the Working Group's Terms of Reference mean that it cannot recommend a comprehensive capital gains tax, due to the distortionary effect this would have in worsening housing affordability. If the Working Group does not accept this submission, we submit that in preference to an Australian-style complex capital gains tax, a comprehensive land tax, or failing that, a tax on the imputed income of home-owner equity, is preferable.

13. We submit that the Working Group recommend that savers should only pay tax on their real interest income – inflation doesn't make savers better off so it should not be taxed
14. We submit that any new environmental tax or water tax proposal should be subject to disciplined and transparent cost-benefit analysis.
15. We submit that any taxes on water should operate in a similar way to water rights pricing and be sector neutral – politicians should refrain from targeting specific industries or uses of water, unless the environmental externalities of the particular use are materially different.
16. As an alternative to recommending specific environmental taxes, we submit that the Working Group develop an objective framework for future proposed environmental taxes to be measured against.
17. We submit the Working Group recommend against the expansion of behavioural taxes, and instead outline the regressive financial damage they inflict on our most vulnerable communities.
18. We submit the Working Group recommend the legalisation of smokeless nicotine alternatives to cigarettes, in preference to continued tobacco tax hikes.
19. We submit the Working Group should acknowledge that our system of GST is the envy of the world and recommend against any changes to our broadly applied and uniform rate of GST.
20. We submit that the Working Group should recommend IRD guidance on cryptocurrencies be rewritten to reflect the true nature of technology and avoid deeming all cryptocurrency as property.