Tax Working Group
Te Awheawhe Tāke

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Future of Tax
EY's submission to the Tax Working Group

April 2018

EY

Building a better working world

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The Future of Tax

Tēnā koe e te rangatira Sir Michael

EY welcomes the opportunity to submit to the Tax Working Group ("the Group").

At EY, we are committed to building a better working world – with increased trust and confidence in business, sustainable growth and development of talent in all its forms. We have asked ourselves the question "How can the tax system contribute to a better working world beyond 2028?"

Our submission contains as many questions as answers. That's deliberate. We'd like the opportunity to contribute to a national debate on tax – we don't seek to dictate solutions.

Many of our recommendations are challenging. They will require further development both as to design and their potential costs and benefits.

The Group has a huge mandate. Your kaitiakitanga function as stewards and guardians of our tax system for future generations is vital.

We look forward to continued engagement.

[1]

Matthew Hanley, New Zealand Tax Leader

Ernst & Young Limited

[1]

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Executive summary

Executive summary

Whāia te iti kahurangi ki te tūohu koe me he maunga teitei

Seek the treasure you value most dearly: if you bow your head, let it be to a lofty mountain

This whakatauki is about aiming high or for what is truly valuable: the Future of Tax is a complex but critical discussion for our country. However, the whakatauki's real message is to be persistent and not to let obstacles stop you from reaching your goal: we offer our submission as a supportive contribution to the Group and this important kaupapa (cause).

We believe a more efficient and equitable tax system is necessary for inclusive growth. That system is achievable in the medium term. The Government will need to make a substantial commitment to tax reform if enduring improvements are to be delivered.

New Zealand's tax system isn't broken

A broad-based income tax with taxing points closely matching cash-flows, a withholding tax based approach, and a comprehensive GST has many benefits. Our tax system has served us well for decades and retains the ability to raise approximately 30% of GDP from our current economy. We do not want the strengths of the existing system to be undermined.

See Chapter 1.

We do not see the current system as sustainable beyond 2028

The Group's Terms of Reference require you to consider the economic environment over the next five to ten years. This time frame is too short. Reforms enacted after the 2020 election will have little impact in this period.

Instead, our tax system – although able to continue to function well for the next decade – needs to adapt to reflect the changing world over the next several decades:

- Technology is changing the nature of business, and of society, faster than at any time in history.
- Workforces, workplaces and the nature of work are changing.
- Environmental issues, particularly climate change, will shape our future.
- New Zealand society is aging and inequality is increasing.

These forces are challenging the broad-base low-rate ("BBLR") approach and how taxes are collected. They seem to us to set out a likely direction of travel for the tax system – more targeted, greater use of behavioural taxes, flexible, transparent and making more use of technology. In more detail:

The future of work

On the future of work, technological change and the gig economy are leading to more short-term roles and rising numbers of contractors. More automation is on the horizon. That's both empowering and threatening for workers.

For our tax system, we believe there's a need to re-examine the current employee/contractor definition and rules around the treatment of allowances and work-related expenses. IRD currently estimates the self-employed under-report their income by around 20%. That cannot be allowed to continue. There's potential for real simplification, and the opportunity to enforce the law by using technology and smart withholding techniques to ensure tax is right first time, every time.

See Chapter 2.

Taxes and productivity

In the long-run our living standards depend on productivity. New Zealand's productivity growth has lagged behind our competitors for

at least 60 years. BBLR takes no account of productivity enhancing behaviour.

There are no easy answers to New Zealand's productivity deficit, but we suggest targeted measures towards capital intensive investment are worth investigating as a way of attracting and retaining investment capital. We acknowledge any form of incentive has issues but the potential gains could be greater than, for example, a small cut in the headline rate of corporate tax. There could be merits in special rules for infrastructure investment, drawing on the Australian and Singaporean experiences.

Small and medium-sized enterprises ("SMEs") in particular are often capital constrained. While there is some logic behind calls for a progressive company tax, the UK experience gives rise to pause on its design. We see SMEs as a prime candidate for an integrated tax system. A truly integrated tax system has the potential to remove the significance of entity form for tax purposes and would be essential to the success of any progressive company tax.

See Chapter 3.

Opportunities for effective environmental taxation

New Zealand's taxes are poorly aligned with the environmental and climate costs of our economic footprint. At 1.3% of GDP, New Zealand's revenue from environmentally related taxes is among the lowest in the OECD.

It is time to assess the role which environmental taxes - on carbon, on energy, on transport – can play in changing human behaviour.

See Chapter 4.

Capital taxation

The current level of wealth inequality challenges the concept of inclusive growth. New Zealand has a private savings shortfall, yet returns from investment are arguably overtaxed.

There is a case for tilting the balance of capital taxation from flows – such as interest and dividends – towards stocks – such as land and other stores of wealth. There seems a greater need for tax related tools to address inequality, potentially rebalancing our system towards taxing wealth, real income and consumption, and away from taxing nominal incomes.

Taxation of capital gains needs to be seen as a part of the overall taxation of capital income and household wealth, not as an isolated issue to address concerns in the housing market.

We retain doubts about the worth of a separate capital gains tax ("CGT") given the family home is to be excluded.

See Chapter 5.

GST is New Zealand's most effective tax

No tax is perfect, but in our view GST comes close in its efficiency as a revenue raiser. While its horizontal equity has been challenged, we see equity as best examined across the tax system as a whole, with changes to GST on these grounds not justified.

See Chapter 6.

Time for a new tax reform process?

When it comes to the process of tax reform, New Zealand has rightly prided ourselves on the Generic Tax Policy Process ("GTPP"). GTPP has delivered tax law meeting the objectives of the government of the day. Given the forces changing today's world, it is now too narrow and too slow. Has the time come for radical reform?

See Chapter 7.

Established criteria for tax reform retain merit

New Zealand is fortunate to have many choices to strengthen our already successful tax system. In making those choices, we endorse the value of established criteria for assessing tax reform. Fiscal adequacy, efficiency, equity and fairness, revenue integrity, compliance and administrative costs and coherence remain important. While trade-offs and weightings between these objectives vary, our suggestions tend to weight efficiency highly. We of course accept others will form different judgments.

Our interest in efficiency leads us to suggest the current tax system takes too little account of the impact of taxes on behaviour. Our BBLR tax system is designed to be neutral between activities. In effect, BBLR is a second best approach to taxation. At least in theory, taxes can be designed to alter behaviour in

efficient, productivity enhancing ways. With ever increasing ability to analyse sophisticated data in real time, there could be opportunities to reform business taxation in productivity enhancing ways.

Given the long term focus of the Group, the intergenerational aspects of the Living Standards Framework will also guide decision-makers. The changes we suggest will, in our view, contribute positively to its Four Capitals.

See Chapter 8 for a summary of our recommendations.

Further analysis needed

Many of the matters raised in our submission need further analysis and research before final recommendations can be made, which hasn't been possible in the time available for submissions.

We will play our part in the national conversation.

Chapter 1

1. Framework for a good tax system

"The original concept of taxation was a simple one; taxes were the means of raising revenue for subsequent expenditure by the ruling authority. In a modern society taxation continues to serve this purpose and remains the primary source of the revenue required by the State to ensure the protection, social welfare, and prosperity of its citizens. But as the political and economic structure of society has become more complex so have the responsibilities of Government increased and, as a consequence, taxation now serves far wider purposes than the simple raising of revenue[1]."

Snapshot

The New Zealand tax system outperforms those in comparable economies.

While sustainable over the next decade, in the medium term the current tax system will find it increasingly difficult to finance spending at around 30% of GDP.

Recommendations

1. Endorse and use established criteria to assess whether the tax system is sustainable.
2. Draw on the Living Standards Framework as a pointer for future work, but not yet for policy recommendations – it remains insufficiently developed.
3. Changes should first be assessed against whether they will damage our existing strong position.

Fifty-one years ago, the Ross Committee - this Group's predecessors - set out the central dilemma for tax policymakers. A tax system needs to generate revenue, but that alone is not sufficient. How should the Group think through the inevitable trade-offs and complexity?

EY sees five key principles for sustainable tax reform

1. The tax system should be capable of raising sufficient revenue to fund the operations of government.
2. Taxes should be raised in a way that is least detrimental to inclusive and sustainable growth.

[1] The Ross Committee (1967) Report of the Taxation Review Committee.

3. Changes to the tax framework must have broad community support and buy-in, which in turn requires our tax system to be clearly progressive.

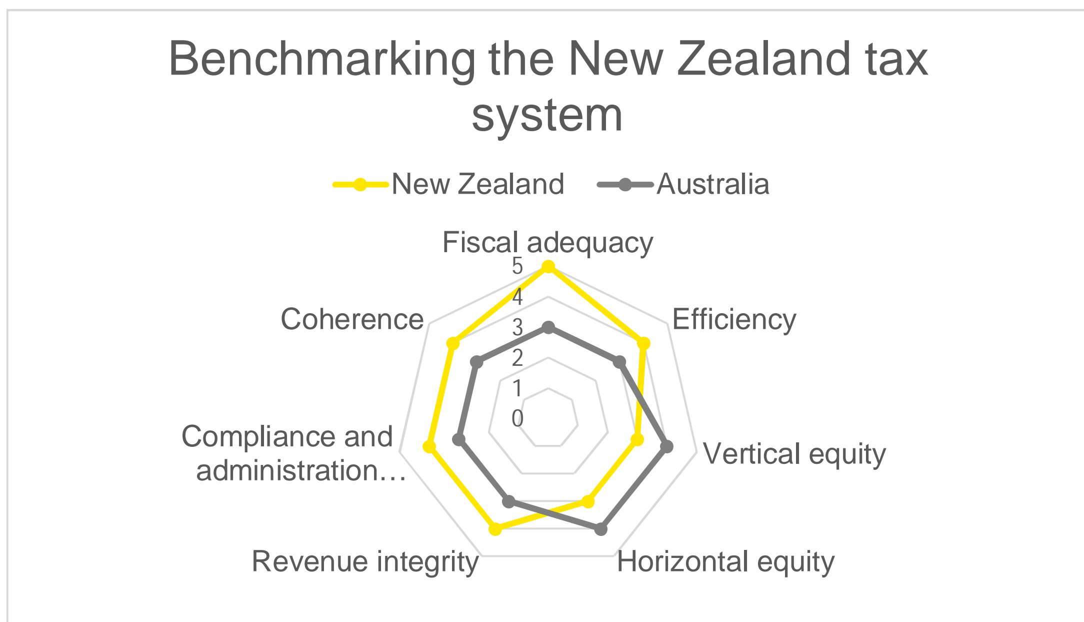
4. The tax framework needs to be robust, yet adaptable, to changing social, economic and technological trends and developments.

5. The tax system and reforms to it should be consistent and coherent, administratively efficient and operationally transparent.

These principles apply regardless of the efficiency of governments in determining operating costs.

Benchmarking New Zealand's tax system

The New Zealand tax system is not currently broken. In our judgment, it outperforms systems in comparable economies such as Australia. Applying the established criteria for tax reform:[2]



Benchmarking approach

The scale (1 to 5 on the benchmarking chart) indicates how our tax system performs across established criteria – with a score of 5 representing absolute best practice and zero an absolute failure across a particular dimension.

We do not expect all tax systems to target a score of 5 across all dimensions. There are trade-offs.

For example, a tax system with a high degree of revenue integrity is likely to face high compliance costs and fall short of maximum efficiency due to complex anti-avoidance legislation. A system which raises little revenue by design may well have a narrow tax base due and therefore be simple to administer, but is unlikely to achieve horizontal equity.

[2] At 19 of the Paper.

Factors behind our judgment are:

Direction of travel	Importance	Current state	Short-term change	Medium-term outlook
Fiscal adequacy ↔	The fundamental purpose of the tax system is to raise the revenue needed to fund the efficient provision of public services that help underpin New Zealand's social fabric.	Tax revenues currently meet government's public finance objectives and, in general, have done so for many years.	None.	The changing nature of economies and a failure of the tax system to evolve will means it becomes increasingly difficult over time to finance the level of spending the community expects.
Efficiency ↗ ↘	After fiscal adequacy, the next highest priority is to configure the tax structure to promote strong, sustainable and inclusive growth.	In a world where it is difficult to measure and isolate taxpayer elasticities, the BBLR system is a good second best.	Boost from pending R&D tax incentive (if well-designed and administered). Challenges from potential digital economy taxes, pending BEPS reforms.	In a globalised world there is mobility of economic activity – both in capital and labour. In the medium term the tax system will have to be re-balanced in favour of indirect taxes relative to income taxes. Business taxation will need to be reassessed. The current model of a source-based approach to taxing business profits may need to be adapted to alternative approaches better able to incorporate digital presence factors.
Equity ↔ ↘	Reality and perceptions about equity both essential to sustainable reform.	Capital taxes have not been fully integrated into New Zealand's tax system, which cannot be categorised as taxing those in similar circumstances in an equal way. Whether income is earned via a PIE, company, trust or individual affects tax liability; income from employment, self-employment, gifts, inheritances or capital gains are all taxed differently.	Ambiguous effects from potential CGT. Challenges from growth in territorial taxation.	The tax and transfer systems will remain the key mechanism through which governments will seek to influence desired income distribution outcomes.
Revenue integrity ↗ ↘		A well-designed system, supportive Courts and professional administration from IRD mean that opportunities to avoid or evade tax are few.	Business transformation, transparency between revenue authorities, pending BEPS reforms, potential CGT, data analytics.	With the breakdown of traditional employment relationships, the 'black economy' may be a growing issue. A rise in activity and peer to peer transactions facilitated through and recorded by on-line platforms potentially opens up opportunities for the tax

Direction of travel	Importance	Current state	Short-term change	Medium-term outlook
			But R&D tax incentives hard to administer.	base to capture previously 'informal' transactions.
Compliance and administration costs ↗ ↘		Comparative studies[3] suggest our tax system is, relatively speaking, easy to comply with and cheap to administer.	Business transformation systems good. But information requests, potential CGT, pending BEPS reforms, changing nature of work, breakdown of traditional families.	Open questions regarding small business taxation. Technology could both simplify and complicate aspects of compliance.
Coherence ↘	Components of the tax system need to sit well when working together.	A BBLR system minimises boundaries, with different forms of income taxed similarly. Pressure points exist around the capital/revenue boundary, notably for property transactions, differential treatment of entities (such as PIEs and Māori authorities) and cross-border taxation.	Pending BEPS reforms, potential CGT excluding family home.	Likely need to redesign building blocks of international tax to take account of digital world and changing balance between direct and indirect taxes.

Our changing world

As the nature and structure of the economy and society changes over time, the tax system must adapt in parallel.

Just as GST was introduced as part of a wholesale reform to a broken and outdated tax system, new challenges are unfolding for the revenue base as digital transformation reshapes many aspects of economic activity. It is changing the way people interact and is raising important issues around jobs and skills, and privacy and security, as well as opening up new opportunities for value creation and fostering new and transformed business models.

The Government could do well to stand still when faced with these challenges though New Zealand cannot stand still for ever. However, a tax system which fails to raise sufficient revenue – whatever its other merits – is a failed tax system. Changes should first be assessed against whether they will damage our existing strong position.

Using the Living Standards Framework

The Living Standards Framework provides a tool for policy makers, although it's not in our view sufficiently developed to act as a guide for specific policy recommendation.

A well-designed tax system will have a positive impact on all four living standards quadrants - natural, human, social and financial/physical.

Taking a Living Standards approach, on average we're well-satisfied with life[4]. Even so, human and social capital problems which should be examined include[5]:

- Jobs - labour market insecurity remains relatively high compared to 2005, and the incidence of job strain has risen by almost

[3] Refer World Bank Doing Business Guide, OECD comparisons.
[4] On the subjective life satisfaction measure used by the OECD (the share of people who report a life satisfaction level below 4 (on a 0/10 scale)), New Zealand outranks all other OECD countries.
[5] These statistics are taken from: OECD (November 2017) *How's Life in New Zealand*, OECD Publishing, Paris, on which the Living Standards Framework draws with approval.

7 percentage points. Working hours are long and time off limited. What implications do the current working environment and the future of work have for our tax system?

- Earnings – real earnings growth is moderate and earnings remain low by OECD standards. Ultimately, earnings are driven by productivity. Can the tax system help us become more productive?
- Housing affordability – a longstanding problem, which has worsened in the past decade, with the proportion of income spent on housing costs increasing from 25.8% in 2005 to 26.2% in 2014. Is this a tax problem?

We have overlaid the Four Capitals within the Living Standards Framework as a directional tool when assessing the impact of our various recommendations in Chapter 8.

Chapter 2

2. The future of work

"A tsunami of change is coming, and we need to prepare now so that no one is left out or left behind."[6]

Snapshot

The gig economy is seeing more short-term roles and rising numbers of contractors.

That's leading both to empowered workers benefitting from flexibility and to an increasingly insecure workforce.

The next step is likely to be a greater use of automation, but the speed of transition in New Zealand should not be overstated.

Recommendations

1. Tax reforms should allow for flexibility in working arrangements.
2. One option would be to create a class of "dependent contractors"; those who have a contractor relationship, but are effectively under a high degree of control.
3. Simplify the tax obligations for dependent contractors, potentially by way of restricting deductions.
4. Develop smart withholding techniques to replicate income tax for dependent contractors (and potentially contractors in general).
5. Apply "dependent contractor" status in a standardised way across all employment laws.
6. Use technology, such as Blockchain, to strengthen integrity of tax administration for individuals.

Our working world is undergoing significant shifts. The future of work provides a nuanced challenge to our tax system. Quiet concerns of the recent past will come increasingly to the fore.

Contractors and the gig economy

Contractors are becoming a significant proportion of the workforce. Forty percent of organisations expect to increase their use of contingent workers by 2021, with 25% expecting to have 30% or more of their workforce made up of them[7]. Labour's Future of Work Commission reports the insecure workforce in New Zealand to be as high as 30%

[6] Andrew Little, *The Future of Work*, New Zealand Labour Party (2016).
[7] EY (2016) *Is the gig economy a fleeting fad, or an enduring legacy?* Ernst & Young, Oceania.

as of 2015[8].

Traditional approaches to employment tax will not in the long-term assist with driving inclusive growth in a modern economy. Nor will they collect tax as easily as in the past.

Why is the gig economy growing?

The model of part-time contractors who hold more than one job is not new. Seasonal agriculture, oil and gas, and other primary industries have been employing similar models for decades[9]. We are seeing more of this trend because there is a significantly increased demand for that type of work. Both employees and employers are increasingly attracted to a contingent workstyle.

Lifestyle is one of the key drivers of demand for gig work. Working in the contingent workforce brings an increased degree of freedom over working days. People increasingly dislike the "nine to five" way of working. From EY reports, we know that 80% of contingent workers see flexibility as the top benefit[10]. Clearly there is an increasing attraction for individuals to shift towards this style of work.

Employers see the benefits of gig workers in the workforce as well. Industries that have employed the model for much longer, such as in agriculture, have done so in response to booms and busts in seasonal demand. While many businesses do not run to the season of crops, there are still seasonal elements. Demand for information technology professionals will peak when new systems need to be rolled out, but in between these updates these skills are surplus to employers. Forty-two percent of businesses surveyed reported they were using contingent workers to meet these needs[11].

There is also increasing demand for specific skills for specific projects. More freelance experts are being demanded by companies to satisfy a need for expertise not otherwise available in-house. Our reports indicate that 56% of businesses use contingent workers for this purpose[12]. Digital recruitment tools are also making it much easier to fill these gaps.

EY operates a platform called GigNow – a global project based employment portal for opportunities with us. This style of recruitment is becoming more common.

What external forces will influence this change?

During the economic downturn of 2008 businesses became attracted to the minimisation of cost that contractual work provides. EY reports show among the S&P 500 organisations, the growth of employment of fulltime workers slowed by nearly a third (2.7% growth, down from 3.9% prior to the recession) [13]. For those affected by this, contract work offered an attractive option. Discovering the benefits of contract work, many have stayed on even after economic recovery.

Recessions are often said to occur, on average, every ten years. With New Zealand's last recession being in 2008/09, it is possible we could see an economic slowdown with a degree of financial hardship within the next decade. We are highly likely to see another frontier push by the gig economy in such an event. It is crucial that the Group recognises the impact this movement is having, and will have, in the work force.

Automation, low wage workers and the near-future

The future of work is increasingly challenged by a global trend towards automation. With labour costs for companies growing in many areas, and automated systems becoming cheaper and more reliable, automation is becoming an increasingly attractive way to shrink costs.

Why has there been comparatively little automation?

Low-skill workers are still comparatively cheaper than machines in many processes. The cost of an employee in New Zealand on the minimum wage is $660 per 40 hour work week.[14] Attaching variable costs such as training and fringe benefits the employee is

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[8] *The Future of Work*, New Zealand Labour Party.
[9] *Is the gig economy a fleeting fad, or an enduring legacy?* At 6
[10] *Is the gig economy a fleeting fad, or an enduring legacy?* At 12
[11] At 9
[12] At 9
[13] At 6
[14] Employment New Zealand, *Current Minimum Wage* Rates, sourced at 20 April 2017: https://www.employment.govt.nz/hours-and-wages/pay/minimum-wage/minimum-wage-rates/

often still more competitive than the costs of implementing and maintaining an automated system.

Indirect costs also pose significant barriers to entry for mass automation. For example, self-service checkouts in supermarkets have been a common sight for years, yet most checkouts are still operated by low wage employees. Self-service checkouts are responsible for a significant increase in theft, with a lack of human oversight emboldening shoppers.[15] The cost of this is significant when tallied, with nearly one in three shoppers reporting some degree of theft.[16] Similar unforeseen costs and inefficiencies are common across all industries, and significantly decrease the attractiveness of automation.

However, at the point where the costs associated with training and maintaining employees outstrips the cost of automation, businesses are highly likely to automate those positions. Further, as the rate of innovation increases, the rate at which companies can minimise the indirect costs of automation will increase as well, incentivising automation.

New Zealand as a target for automation testing

New Zealand is an attractive testing ground for new processes. New Zealanders are (on a global scale) highly educated, have high incomes and speak English. We share a strong similarity with consumers of key markets such as the US and the UK.

Our relative distance from those key markets is important too. The poor reception of a particular new process or product influences the opinion of consumers in California less than the same reception coming from customers in another state of America. Because of this New Zealand is often the first consideration as a test environment for tech companies. Facebook and Microsoft are increasingly testing more features and apps in our market first and making changes to their models from our reactions.[17]

Wages increasing the speed of automation

New Zealand has recently announced it will increase its minimum wage to $20 by 2021. With a 27% increase in the cost of minimum wages the cost of each employee will shrink significantly compared to automated systems. In a global environment conscious of the cost saving potential of automated systems, New Zealand will present a timely test environment for these systems.

We are likely to see a unique degree of labour displacement in the coming years. More and more New Zealanders in low-wage employment will change the nature of their work, and in turn, change the nature of the working world around them. What form that work is likely to take is a broad and difficult question, but it will certainly increase the population of those participating in a more mobile and digitally-dependent workforce.

Growing difficulty with the tax process

For those participating in this kind of work there is a growing difficulty in reporting tax properly. Many individuals transitioning into the contingent work force have never been responsible for their own reporting – relying on PAYE to manage their obligations where such reliance can be misplaced. Recent research by IRD and Victoria University highlights this issue, estimating the average underreporting of self-employed and contractual workers at 20% on average.[18]

As emphasised in that report however, this does not necessarily mean that is wholly the result of intentional underreporting. The same research indicates 90% of New Zealand's workforce feels that properly paying tax is the right thing to do. The figures indicate there is a significant proportion of this population of taxpayers that are simply making mistakes. IRD has recognised the need to simplify the tax process, especially for the contingent workforce.

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[15] Emmeline Taylor (2016) *Supermarket self-checkouts and retail theft: The curious case of the SWIPERS*, British Society of Criminology. 3.
[16] At 4
[17] The Economist (2015), *Kiwis as Guinea Pigs*, sourced 19 April 2017 at: https://www.economist.com/news/business/21651858-small-technophile-country-great-place-test-digital-products-kiwis-guinea-pigs
[18] Victoria University (2018), *Estimating self-employment income-gaps from register and survey data: Evidence for New Zealand, Victoria University Press.*

The future of workplace tax

The greatest challenge we face is ensuring we don't throttle innovation in the working world with a taxation structure that is too inflexible. New Zealand is often praised as a world leader in its taxation structure – we should endeavour to maintain this reputation.

A blurred line – who is an employee and who is a contractor?

The current legal scheme for determining who is a contractor and who is an employee is too ambiguous. With the scheme dependent on interpreting case law rather than legislation businesses and contractors are often confused. If the trend towards increased gig work continues we need to clarify who a contractor is for tax reporting purposes.

What solutions might exist?

In the case of contingent workers, there can be real confusion as to who is ultimately responsible for withholding and reporting tax. Legislative intervention to create new classifications of workers would be highly helpful. There is a compelling case from a recent UK report to create a classification of "dependent contractor"; those who have a contractor relationship as per the current scheme, but with a higher emphasis on the degree of control.[19] A new class such as this would allow for the proper classification of contingent workers, and attach to those individuals specific reporting requirements.[20]

As the contingent workforce grows the number of individuals with personal reporting obligations will grow. Importantly, this will mean the population of contractors will be comprised increasingly of individuals who historically had their tax obligations handled by their employer. The risk of these individuals getting their tax obligations wrong is likely to be high. IRD will be faced with an increasingly large task of investigation if this is not resolved. In the interests of an equitable and efficient taxation system, we would stress the importance of a change.

One possibility could be to replicate the position of employees – no tax deductions for costs associated with delivering services as a dependent contractor. If this is seen as a step too far, deductions could be simplified and standardised.

Innovations in tax collection

With many of the more ambiguous gig economy roles facilitated by the digital economy there is scope for experimenting with methods of withholding tax at the point income is earnt. Russia has recently implemented a Value Added Tax (VAT) that specifically targets the provision of digital services.[21] Where a digital service is provided to a Russian resident, regardless of the country of residency of the digital service provider, the value of the service is taxed at 15.25%.[22] The tax is deducted at the point of the sale, but rather than the tax being withheld by the service provider, it is immediately debited to the Russian Government.[23] This system has allowed the Russian Government to effectively create an income tax withholding system for gig workers.

This system has the potential to significantly minimise the revenue lost from reporting errors. It also provides a valuable asset in real-time data of earnings of contractors, allowing smarter policy to be formed into the future. New Zealand could greatly smooth the reporting obligations of those who are confused by their reporting obligations by exploring a similar model.

The changing demands of employment rights

One of the core benefits an employee has over a contractor is access to statutory employer requirements. An employer must pay at time and a half over holidays, to provide a minimum number of days off in a given year, and to provide KiwiSaver contributions to an employee's scheme. Contingent workers are increasingly reporting that while they enjoy the

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[19] Mathew Taylor (2017), *Good Work: The Taylor Review of Modern Working Practices*, Royal Society of Arts. 35.
[20] At 35

[21] EY (2018), *Russia revises VAT rules for electronic services provided by foreign companies*, Ernst & Young Russia. 2.
[22] At 2.
[23] At 3.

relative freedom gig work offers, the loss of these benefits is a significant concern.[24]

There have been many challenges to the legal status of gig workers during the past four years, and different jurisdictions with similar legal frameworks have come to very different answers.[25] As a result, there are serious concerns for businesses with large populations of gig workers. By clarifying the rights of gig workers with tighter employment relationships than status-quo contractors we would ensure that disputes about proper classification are minimised.

There is a distinction between who is a contractor for tax purposes and who is a contractor for employment rights purposes, but this is often misunderstood. In the interests of both equity and efficiency it is our view there would be significant value in aligning the definitions. Should there be a review of the classifications for tax purposes, this should be replicated for employment rights as well.

Blockchain as a solution

One of the biggest vulnerabilities of the tax system to the growth of the contingent workforce comes from the wide spread of tax information. Information needed to properly complete a return is required from many sources, and the more people responsible for providing information the more likely you are to see errors or double ups in data. Where there are errors, people (intentionally or unintentionally) will under report taxable income by going with the most favourable set of information. An interesting solution to this problem is Blockchain. The diagram overleaf demonstrates how this system might work.

How might Blockchain be utilised?

As the diagram shows, the most significant benefit of Blockchain in tax reporting is that it requires everyone to update just one source of information. Blockchain also allows you to specify who is and isn't allowed to alter information, ensuring self-interested or careless individuals cannot interfere with proper reporting. By doing both of these things reporting can be made much easier for everyone involved, while also minimising otherwise significant administrative costs. Further IRD would have access to a much tidier pool of information, making its role of verifying reporting much less burdensome, and making investigating fraud or errors much easier

The Future of Government Assistance

Given the trend of automation, in the long run there is likely to be a rise the number in marginalised workers. Demographic trends dictate there will be many older New Zealanders, with more complex needs and requiring a higher standard of care.

We predict higher demands will be placed on government assistance in future decades and fewer employees in the traditional sense. As this trend grows, income sourced exclusively from employment is going to become increasingly scarce.

We don't have a ready solution without making radical changes to the tax and transfer system going beyond the Group's mandate.

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[24] *Is the gig economy a fleeting fad, or an enduring legacy?* At 13.

[25] University of Oxford (2017), *The Employment status of Uber Drivers*, University of Oxford, Oxford. 13-95.

Employer and Contractor create a digital contract that gets saved onto a blockchain system, containing required material for proper reporting
Employer and Contractor update the information whenever a payment is made, which is then sent straight to the IRD to verify
The Blockchain Information
The information is automatically sent to a third party who verifies everything reported. When satisfied, it updates the Blockchain information

Chapter 3

3. Taxes and productivity

"Productivity isn't everything, but in the long run it is almost everything. A country's ability to improve its standard of living over time depends almost entirely on its ability to raise its output per worker[26]."

Snapshot

New Zealand's productivity growth has lagged our competitors for at least 60 years. That feeds through to the living standards of us all.

Ensuring the tax system doesn't inhibit productivity and innovation can play a part in inclusive growth over the next decades.

Our current BBLR system takes no account of productivity enhancing behaviour.

Recommendations

1. Consider reforms to the corporate tax system to enhance productivity.
2. To that end, further investigation of:
   a. Targeted measures which may have a more significant impact on business investment,
   b. Bespoke rules for SMEs based on the integration principle, and
   c. Whether design challenges associated with progressive corporate tax rates for SMEs can be overcome.
3. Consider rebalancing taxes towards immobile factors such as land.
4. Where possible, tax at the corporate level should be fully integrated with tax at the ownership level:
   a. For smaller businesses, seek to achieve full integration.
   b. For larger businesses, imputation remains the best approximation of integration.
   c. Extend Māori authority regime to include wholly owned subsidiaries.
5. New Zealand should respond to tax challenges caused by digitalisation of the economy:
   a. Investigate nexus, profit allocation rules and place of consumption for digital businesses.

[26] Paul Krugman (1994), *The Age of Diminishing Expectations*, MIT Press, New York.

b. Monitor digital services tax developments, for example, current EU proposals.

6. Radical reform to New Zealand's corporate tax base or taxation of SMEs is not currently required.

Note these recommendations are finely balanced, as:

1. Economic literature provides sufficiently strong advice on a general direction of reform, but not on the size or enduring growth effect.
2. Studies are not based on New Zealand data so take little or no account of imputation.
3. Other policy priorities, such as coherence or ease of administration may outweigh the productivity benefits of corporate tax reform.
4. Both economic theory and country practice will develop in the next decade. Other countries may overcome the practical and theoretical challenges of radical reform. In that case, New Zealand should consider becoming a fast follower of other productivity enhancing reforms.

New Zealand's current tax structure aims to be coherent. In general, it:

- taxes a broad base of income at low rates,
- makes extensive use of withholding taxes at times close to the associated cash flows,
- attempts a neutral treatment between different assets and entities, and
- historically sought to align the tax rate of entities with the top personal tax rate.

BBLR is a second-best approach to taxation

There is much to be said for this simple neutral treatment.

But it is not perfect. *"In principle, the most efficient taxes are not broad-based and low-rate taxes but taxes whose rates are higher the less sensitive are activities to tax (or, in economists' jargon, the less elastic are activities)."*[27]

New Zealand has backed away from seeking to tax more efficiently in favour of using a broad-based, low-rate approach because governments over several decades have doubted their ability to make distinctions based on elasticities or on value judgments around fairness.

But is that selling New Zealand productivity potential short? New Zealand depends on inbound investment[28] for which there is no obvious best means of taxation. Many commentators have concerns about the high levels of capital taxation and some economic models suggest it is optimal for a Small-Open Economy (SOE) such as New Zealand to levy no tax on inbound capital.

We are not suggesting zero taxation on inbound investment or that economics gives a strong case for substantially lower capital taxation. We are, though, suggesting the time is right to reassess whether our system of corporate taxation could do more to enhance productivity. In particular:

- Does our relatively high corporate tax rate reduce productivity?
- Is there a case for targeted investment incentives given the potential importance of keeping the corporate tax rate high?
- Is there a case for differential taxation of small, domestically owned businesses, based on the integration principle?
- Should our tax base be rebalanced towards immobile factors of production such as land?

Existing policy choices

New Zealand has already chosen to depart from neutral, broad based, low rate taxation for

[27] Victoria University (October 2009), *Company tax issues facing New Zealand: Background paper for Session 4 of the Victoria University of Wellington Tax Working Group*, Victoria University Press, Wellington.
[28] For New Zealand, FDI is the main form of inbound equity investment. As at December 2015 the stock of foreign direct equity investment was $66.4 billion and the stock of FPI equity investment was $33.5 billion.

fairness, efficiency or coherence reasons in certain areas:

- The top personal tax rate has not been aligned with the corporate tax rate since the 1999/2000 income year[29].
- The PIE rules set a maximum tax rate for investment vehicles of 28%.
- The income of a Māori authority is taxed at 17.5%.
- Charities are not taxed on trading income.
- R&D activities will shortly be in receipt of a 12.5% tax incentive.
- Certain capital gains are not taxed, with - in the case of the family home – an all-party agreement not to tax them.

We therefore have form when it comes to adapting BBLR as evidence emerges that such changes are necessary.

Importance of productivity

New Zealand's productivity has been in a period of relative decline for at least the Past 60 years, during which time we have gradually drifted down the OECD productivity ladder (we're now 21st).[30]

While our national income can be divided in different ways, and there are real questions about inequality, without growth in that national income, living standards – however measured – will remain below those in richer countries. Any moves towards greater fairness depend ultimately on increasing productivity.

"Generally speaking, the higher the productivity of a country, the higher the living standards that it can afford and the more options it has to choose from to improve wellbeing. Wellbeing can be increased by things like quality healthcare and education; excellent roads and other infrastructure; safer communities; stronger support for people who need it; and improved environmental standards."[31]

Lifting productivity is a priority for the current Government. There is no single way to achieve this, and we would not argue tax settings are central to productivity. Even so, factors include an attractive business environment, investment and smart technology. Tax can influence these factors.

Corporate tax rate can impact on economic growth

The economic literature around corporate taxes and growth has limitations. Nevertheless, it paints a suggestive picture.

Generally speaking, several propositions emerge:

- Tax increases appear to reduce growth.
- Tax increases appear to reduce investment more than consumption as components of GDP (although both fall).
- The effect is heterogeneous in that smaller firms are more impacted in their investment decisions than larger firms, possibly supporting a progressive/differentiated corporate tax.
- The tax rates of a country negatively affect decisions to direct investment in that country.

We accept these studies do not directly account for imputation systems, that high corporate taxes may be required to keep New Zealand's tax system coherent, and that location-specific economic rents and sunk investment costs provide reasons to keep New Zealand's corporate tax rate high.

Probably the leading macroeconomic study in this area (Romer and Romer)[32] demonstrates the negative effect an increase in tax levels has on growth. Investment appears to be more sensitive to tax levels than consumption as noted above.

Arnold et al[33] draw similar conclusions in a more policy-based paper. This paper sets out to

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[29] The period of non-alignment – 18 years and counting – now exceeds that of alignment (11 years).

[30] OECD Productivity Indicators (2017).

[31] Productivity Commission (2017) *Why is productivity important?*, accessed 9 April 2018 from: https://www.productivity.govt.nz/about-us/why-is-productivity-important

[32] Romer, Christina D. and Romer, David H (2010), *The Macroeconomic Effects of Tax Changes: Estimates Based on a New Measure of Fiscal Shocks*, American Economic Review 100. 763–801

[33] Jens Matthias Arnold, Bert Brys, Christopher Heady, A˚sa Johansson, Cyrille Schwellnus and Laura Vartia (February 2011), *tax policy for economic*

consider the implication of tax structures on long-run growth. It uses a panel of 21 OECD countries over 34 years to estimate the effect of tax structure on growth in the short and medium run. It also takes a look at micro mechanisms by using data at industry and firm level to estimate the effect of tax structure on investment and productivity growth, which the researchers consider to be the two main drivers of economic growth. Findings:

- Empirically, economic growth can be increased by gradually moving the tax base towards consumption and immovable property.
- Ranking of tax instruments for growth (from least to most harmful):
  - Recurrent taxes on immovable property.
  - Consumption taxes and other property taxes.
  - Personal income taxes.
  - Corporate income taxes.

While such studies appear robust at an aggregate level it is fair to note there is scepticism about the ability to place strong reliance on them through the need to control for outside factors such as the economic cycle, or changes in the quantum and incidence of tax through planning.

It is also unclear whether the growth impact would endure beyond the short-run (say five to ten years).

Corporate tax impact on investment location choices

Anecdotally, we already see US tax reform influencing investment location decisions among our clients. This is backed up by the Oxford University Centre for Business Taxation. *Taxes and the Location of Targets*[34]. This demonstrates how the corporate tax rates of a host country and the tax system of the acquirer's country (territorial or worldwide) affects the merger and acquisition target choices of domestic and multinational enterprises. Findings include:

- Host country tax rates have a negative effect on the probability of an acquisition in that country.
- But where the corporate rate of the target is lower than the acquirer's country, and when the acquirer's country operates a worldwide tax system that allows a credit for foreign tax paid, the corporate tax of the target country plays a much less significant role, or no role at all.

While the study does not take account of imputation, imputation credits are of little use to overseas investors, therefore its conclusions remain broadly valid. We understand the strong reasons for continuing to charge high levels of corporate tax on foreign investment, including location-specific economic rents, sunk costs of existing investment, coherence of our tax system, and perceived equity issues.

No immediate cut to corporate taxes

The various reservations are sufficiently strong and the economic case insufficiently compelling for us to recommend an immediate cut in corporate taxes.

One reason is that our existing, well-functioning, imputation rules mean much of the of a corporate tax rate benefit might flow offshore. Also, the revenue and growth from new investment would take time to emerge.

The issue is one to keep under medium-term review.

Tax incentives

Is there a case, alternatively, to target interventions towards capital intensive investment? Historically, most tax incentives have failed but there may now be grounds to revise that viewpoint:

- Globally, interest in incentives is increasing, there are valid grounds for that interest, and proper targeting and design is essential to the success of an incentive.

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recovery and growth, The Economic Journal, 121 F59–F80,

[34] Arulampalam, W, Devereux, M, and Liberini F (2017), *Taxes and the Location of Targets WP 17/04*, Oxford University Centre for Business Taxation.

- The strongest case for incentives appears to be as a form of tax competition in a constrained world, as a way of attracting and retaining investment capital. Targeting reduced taxes at the most mobile forms of capital may be a rational position.
- The test for the beneficial impact on investment by firms benefiting from tax incentives should be analysed in light of the effect of aggregate investment.
- Availability of sophisticated data, analysed in real time, gives a better chance of designing and administering a smart, targeted incentive than ever before. This is a new factor, giving advocacy of tax incentives to alter behaviour greater weight than before.

This is a subtle argument – it's not as clear-cut as "tax incentives = good for business". We acknowledge tax incentives are fraught with risks, including their use by immobile local firms, distortions of capital allocation, increased complexity, administrative difficulty and reduced transparency around effective tax rates. These drawbacks will need to be traded off against the potential economic advantages of being able to combine raising high capital income taxes while remaining competitive for mobile activity.

Incentive design

Any incentives should be transparent, predictable and stable over time if they are to influence investment decisions. That tends to support investment allowances and tax credits rather than tax holidays, financing incentives, special economic zones or tariff/trade tax exemptions. Generous depreciation schemes or capital allowances/tax credits tend to work well for marginally profitable capital intensive projects, which could be relevant given New Zealand's infrastructure shortfall.

Infrastructure

Infrastructure is an area of particular interest. The costs of delay are substantial.

Adequate infrastructure is a key element of enhanced productivity, which augments population and participation to build economic growth[35]. Transport infrastructure to enhance the logistics of transporting goods, and people located in cities, is as important as communications and other social infrastructure.

If enabling infrastructure development during the last ten years was characterised as being a question of financing ("how should the investment be structured?"), then the next decade is likely to be about funding ("who has the desire to cover the cost?") Many infrastructure projects are too big to be funded within New Zealand: an international component is essential.

Currently, infrastructure funding tends to occur through special purpose vehicles. Would a more nuanced tax system help to speed infrastructure development? Is it worth giving up some tax revenue now in exchange for the economic advantages of faster infrastructure development in the future?

Many potential international infrastructure funders are tax exempt. Any New Zealand tax impost on sovereign wealth funds or pension funds is likely to be irrecoverable and to act as a disincentive to New Zealand investment.

The case for special treatment of inbound infrastructure investors is strong. As a counter argument, allowing international investors access to special treatment can be seen as problematic. Various countries have sought to reconcile the need for foreign direct investment into infrastructure with appropriate domestic tax collections. The recent Australian experience shows both sides of the equation.

[35] The Australian Treasury uses the 3Ps of population, productivity and participant as key factors in driving economic growth: see the for example Where is the Growth Going to Come From? Reserve Bank Assistant Governor (Economic) – 15 November 2017, at https://www.rba.gov.au/speeches/2017/sp-ag-2017-11-15.html

Example: Productivity and the infrastructure investment pipeline in Australia

Innovative financing approaches are having a greater role in Australian infrastructure development and the PPP model, encouraging private sector investment and outcomes for state and local governments. Australian governments have used multiple funding mechanisms to finance infrastructure development including asset sales, debt, PPPs, federal grants, value capture and concessional loans. PPP investment opportunities attract Australian superannuation funds (pension funds) and international investors.

When combined with existing concessions used by foreign pension funds and sovereign wealth funds, some foreign investors can pay tax rates of 15% or less (in some cases, almost tax-free), rather than 30% on Australian business income.[36]

There has been concern about the overall income tax framework as, over recent years, a growing number of taxpayers have sought to re-characterise trading income into more favourably taxed passive income.[37] The use of stapled structures to access reduced Managed Investment Trust ("MIT") withholding tax has been the subject of Australian Taxation Office and Government scrutiny.[38]

This led to the release of a revised Australian Taxation Office infrastructure investment framework on 31 January 2017 and recent announcement of integrity measures to apply from 1 July 2019 to limit access to the lower MIT rate, with transitional rules for certain existing projects.[39]

Example: Singapore tax based incentives to help fund infrastructure development

Singapore sees infrastructure financing incentives as important.

It has a package of discretionary tax incentive schemes for project and infrastructure finance which are targeted to promote the attractiveness of non-bank infrastructure financing for investors seeking alternatives for long-term investments in infrastructure-related projects in Asia.

The incentives include:

- Exemption of qualifying income from qualifying project debt securities
- Exemption of qualifying income from qualifying infrastructure projects or assets received by approved entities listed on the Singapore Exchange (SGX), and
- A 10% concessionary tax rate on qualifying income derived by an approved infrastructure trustee manager or fund management company from managing qualifying SGX-listed business trusts or infrastructure funds in relation to qualifying infrastructure projects or assets.

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[36] Levelling the playing field for Australian investors: Taxation of Stapled Structures http://sjm.ministers.treasury.gov.au/media-release/024-2018/

[37] https://www.ato.gov.au/law/view/document?DocID=TPA/TA20171/NAT/ATO/00001

[38] The MIT regime was aimed at increasing the attractiveness of Australia's fund management industry (especially commercial and retail property funds) to mobile foreign investment. It did this by lowering the withholding taxes on certain distributions of passive income to foreign investors, particularly rental income. In recent years, the withholding tax rate has generally been 15 per cent. It followed that foreign investors in certain stapled business structures could also access reduced withholding rates on certain passive income (rather than be effectively subject to tax at the corporate tax rate) if the trust side of the staple was a qualifying withholding MIT. These stapled structures included a broad range of infrastructure projects including in social infrastructure and privatisation of Government businesses.

[39] Tax treatment of stapled structures https://treasury.gov.au/publication/p2018-t273732/

Integration and Imputation

Business taxation can follow one of two broad approaches – taxing the business in its own right or attributing that tax base directly to its owners – in substance, integrating the company with its owners.

In principle, we prefer the latter approach, as it allows the individual circumstances of the owners to be taken into account.

Look-through treatment is not always possible, particularly where there are many owners. And it may not always be desirable, for example, where New Zealand wishes to tax income beneficially owned by non-residents on a withholding basis.

Imputation provides an effective step towards integration for domestic residents and we endorse its retention. An imputation system therefore reduces the case for a corporate tax cut. One possible improvement would be to allow for refundability of surplus imputation credits to New Zealand tax residents as fiscal conditions allow. This would be a step towards integration.

The default tax treatment for widely-held entities should be the corporate treatment (including approximations of that treatment).

The default tax treatment for closely-held entities should be the partnership treatment (including approximations of that treatment).

A particular benefit of full integration is that entity form and tax rate become much less significant. It supports progressivity as it stops income sheltering through entities. If tax liability will in some form be attributable to the beneficial owner of an investment, then the treatment of income in a widely-held company, trust, limited partnership, portfolio investment entity etc. becomes of much less significance.

Small business taxation – integration in practice?

In a further productivity study,[40] Gemmell et al find higher rates of corporate taxation slow the rate of convergence to the productivity frontier for small firms (defined as twenty or fewer employees). One possible explanation for this is that because smaller firms are more likely to be credit constrained, they are more reliant on retained profit for investment, which is reduced by corporate taxes.

Gemmell et al's findings suggest there is a case for investigating a separate regime for SMEs.

Conversely practical experience to date suggests differential taxation for SMEs can be distortionary and ineffective/inefficient at stimulating job growth or innovation.

Example: UK Experience with corporate tax reform

The UK sought to encourage growing businesses by reducing corporate taxes for SMEs.

Over the period 2001/02 to 2006/07 (at which point the incentive was abolished):

- Corporate tax rate was reduced to 10% (0% from 2002/03 to 2006/07) for profits between £0 and £10,000.
- A lower small-profits rate applied up to £300,000
- Tapering marginal relief applied for profits between £300,000 and £1,500,000

Amendments occurred during this period attempting to ensure the system worked as intended.

Devereux and Loretz examined the UK's experience with marginal corporate tax rates in the 2000s.[41]

Findings included:

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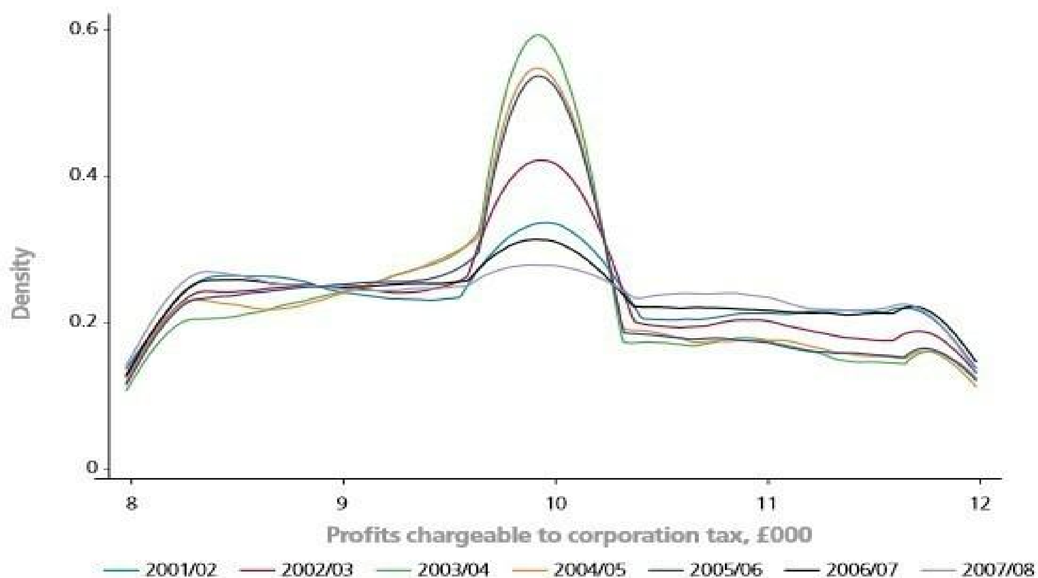
[40] Gemmell, N, Kneller, K, McGowan, D, Sanz, I and Sanz-Sanz, J (2018), *Corporate Taxation and Productivity Catch-Up: Evidence from European Firms*, Scand. J. of Economics 000(0). 1–28..

[41] Michael P. Devereux and Simon Loretz (2011), Corporation tax in the United Kingdom, Oxford University Centre for Business Taxation, Oxford.

- A spike in new incorporations coinciding with the implementation of a 0% starting rate.
- Profit 'bunching' at kinks in the marginal corporate tax rate.
- Closely held companies changing the way the owners extracted income from the companies, switching between wages/self-employed income and dividends. (This is less of a problem with an imputation system.)
- Distortions to investment patterns in situations where the value of "capital allowances" (depreciation) depended on marginal tax rates.

The chart below, taken from Devereux and Loretz shows the 'bunching' effect at the £10,000 threshold.

Lessons learnt from this failed reform include:



- Size linked with legal form, as in a progressive corporate tax, is a poor design for special relief.
- Failed reform of this kind is expensive.
- Targeting specific activities or particular market failures has a greater prospect of success.

The UK experience suggests a conflict in developing a progressive corporate tax model for SMEs. Giving lower corporate tax rates for SMEs has productivity advantages (Gemmell et al) but integrity disadvantages (Devereux and Loretz).

Singapore will shortly expand its range of incentives for SMEs.

Example: Singapore incentives for smaller firms

Currently, Singapore has in place two broad-based tax schemes to support smaller firms and start-ups without eroding the premise that every profitable company should pay some taxes. During its recent 2018 budget, there were further refinements starting in the 2020 year of assessment 2020:

- A Partial Tax Exemption scheme which provides for 75% exemption on the first S$10,000 of normal chargeable income (NCI) and 50% exemption on the next S$190,000 of NCI.
- A Start-Up Tax Exemption scheme for qualifying companies which provides for 75% exemption on the first S$100,000 of NCI and 50% exemption on the next S$100,000 of NCI.

In addition, Singapore has also in place some temporary targeted measures to tide firms especially the small and medium entities with near-term cost pressures.

We are not convinced it would yet be possible for New Zealand to overcome the problems apparent in the UK. Given the theoretical appeal of such rates as a productivity tool, further investigation on potential design would be worthwhile. Full integration between small companies on a progressive tax rate and their owners would be an essential component of reform. Otherwise it would be too easy for a high net worth individual to route funds through a series of small companies.

We do, however, see differential treatment about integration as being justified. A truly integrated approach for all small businesses would allow owners to take advantage of progressive personal tax rates more completely than is currently the case.

Māori authorities – integration in practice

One example of semi-integrated taxation is the system of Māori authority taxation. Tax rules specific to Māori authorities follow on from the unique way Māori freehold land and other tribal assets are administered and owned, including communal ownership and restrictions on the ability to sell.

Māori authority taxation sits between imputation and full integration. A Māori authority pays tax at a low rate of 17.5% on retained earnings, and operates a credit attribution system, similar to the company imputation model. A crucial difference is the Māori authority tax credit is refundable to the extent the members do not have a tax liability against which it can be offset.

This model in practice works well and we endorse its retention. Improvements needed are:

- Wholly owned and controlled subsidiaries of Māori authorities should also qualify for Māori authority status. We understand this was proposed by officials at the introduction of the regime. The policy merits still hold, and this omission has created unnecessary tax and compliance costs for Māori authorities.
- Post-settlement governance entities (PSGEs) for Treaty of Waitangi settlements should be permitted to be established after the settlement process is complete (e.g., within a 12 month period from the settlement date). The current legislation and policy requires PSGEs to be established before receipt of settlement redress and contemplated in the deed of settlement. This limits flexibility needed for innovative settlements or under-resourced claimant groups.
- The default RWT rate for Māori authority distributions when the recipient does not provide an IRD number (currently 33%) should be the Māori authority tax rate. A significant proportion of distribution recipients are unknown (particularly in long-established Māori land entities) meaning there is likely a significant excess of RWT being withheld by IRD for these distributions.

Tax challenges caused by digitisation of the economy

Digitisation is a leading example of technological change. The digital tax landscape is altering and will alter the future of business in unpredictable ways.

Put simply, digitisation now underpins business, and allows businesses to operate globally with much less friction, in a more mobile manner.

This digitisation was a key driver of the OECD's work program to counter base erosion and profit shifting. However the analysis of tax policy directions for the digital economy, Action 1 of the BEPS project, was held over pending the other actions.

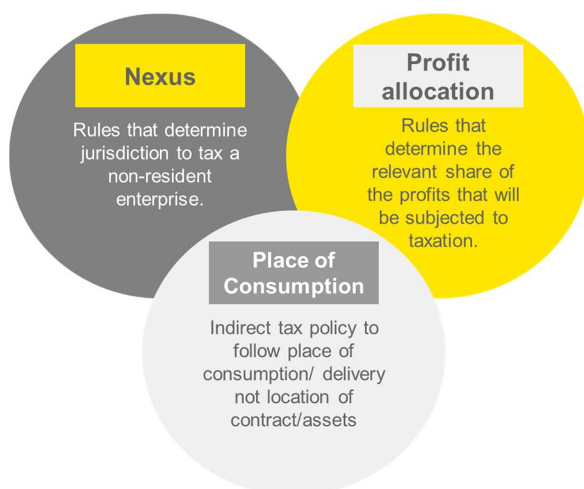
So the OECD's valuable BEPS recommendations have in effect patched up existing international tax law but not yet set out a compelling vision

for the future. We – and the G20 – await its final recommendations to be developed in coming months for delivery by 2020.

The digital economy will be the next battleground for fundamental tax reform. Three areas provide particular challenges for taxing authorities:

- Businesses can supply digital services where they are not physically established – *"scale without mass"*,
- The development of specific software such as social platforms allowing user interaction – *"reliance on Intellectual Property assets (IP)"*, and
- The value from the business perspective comes from the participation of the users in the digital activities that they offer – *"user value creation."*

In response we recommend the Group looks further into nexus, profit allocation and place of consumption.



A watching brief on digital services tax in New Zealand

There is significant global political support for an interim digital services tax, led by the European Commission. The OECD rightly notes: *"There is no consensus on the need for, or merits of, interim measures, with a number of countries opposed to such measures on the basis that they will give rise to risks and adverse consequences."*[42]

For New Zealand, we do not feel the time is right to follow the European Commission push for a 3% digital services tax. Interim taxes such as a digital services tax tend not to be temporary. Other challenges include:

- advertising revenue splits between countries,
- potential economic incidence of taxation on business – loss making businesses,
- difficulties in achieving compliance (use of algorithms, etc.),
- location of users,
- insufficient rewards to developer of IP,
- double or over taxation, and
- barter services.

While these challenges are as relevant for New Zealand as for other economies, we have a strong corporate taxpaying culture and no immediate pressing revenue problem. We are concerned that if New Zealand moves quickly to tax the digital economy, that may actually encourage unilateral moves and foster further instability in international tax systems.

Instead, we recommend taking a watching brief on digital tax developments. We would not rule out following experiences in other countries as a part of wholesale corporate tax reform in the medium term. Reducing corporate taxes could be a reasonable trade-off for entering into a digital services tax in the future.

Radical company tax reforms

A substantial body of literature, dating back to Meade[43], has put forward the case for radical corporate tax reform under a range of economic models.

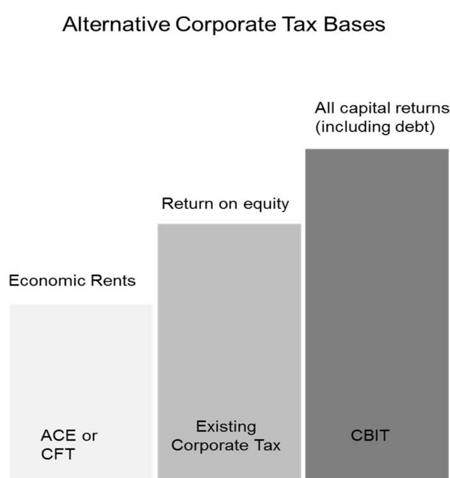
Many of these reforms have strong theoretical appeal, in that they target an alternative corporate tax base with potential gains to the overall efficiency of revenue raising.

[42] OECD Secretary-General Report to G20 Finance Ministers and Central Bank Governors (March 2018).

[43] J.E. Meade (1978), *The Structure and Reform of Direct Taxation: Report of a Committee chaired by Professor J.E. Meade*, Institute for Fiscal Studies.

In particular, both the Allowance for Corporate Equity (ACE) and the Comprehensive Business Income Tax (CBIT) target an arguable systematic bias in favour of debt over equity in standard corporate taxes. The ACE does this by allowing a notional deduction for the cost of equity, the CBIT by way of denying a deduction for interest costs.

The different tax bases targeted by ACE and CBIT are shown below.



They have been implemented rarely in practice, making it difficult to assess their likely impact. The Victoria University of Wellington Tax Working Group put this dilemma well, in its discussion of one such alternative – a dual income tax combined with an ACE:

"While the TWG thought this approach was innovative and may be worth considering at some time in the future, a system like it is untested (it has never been implemented) and it also raises significant transitional and implementation issues."[44]

While ACE in particular has seen a degree of uptake,[45] this comment remains valid in our view and radical company tax reforms are not discussed further in our submission.

[44]Victoria University (January 2010) *A Tax System for New Zealand's Future*,Victoria University Press, Wellington.. 43.

[45] Variants of ACE systems have been introduced in Belgium, Cyprus, Italy, and Turkey but this is not yet a sufficient sample to assess the system's long-term sustainability.

Chapter 4

4. Opportunities for effective environmental taxation

"We stand now where two roads diverge. But unlike the roads in Robert Frost's familiar poem, they are not equally fair. The road we have long been traveling is deceptively easy, a smooth superhighway on which we progress with great speed, but at its end lies disaster. The other fork of the road – the one less traveled by – offers our last, our only chance to reach a destination that assures the preservation of the earth."[46]

Snapshot

The Government has committed to action on climate change.

Our taxes are poorly aligned with the environmental and climate costs of our economic footprint. At 1.3% of GDP New Zealand's revenue from environmentally related taxes is among the lowest in the OECD.

Recommendations

1. Tax should be part of the Government's toolkit for dealing with environmental issues.
2. The Group should agree good principles for environmental taxation including:
    a. An initial presumption against the introduction of selective taxes tempered by the understanding that the Government's international commitment to take transformative action on climate change is compelling.
    b. Environmental tax bases should be targeted to the pollutant or polluting behaviour.
    c. The scope of an environmental tax should match the scope of the environmental damage.
    d. The tax rate should be commensurate with the environmental damage.
    e. The tax must be credible and its rate predictable.
    f. Distributional concerns should be addressed through other policy instruments.
3. There is a prima facie case for further investigation of:

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[46] Rachel Carson (1962)., *Silent Spring*, Houghtin Mifflin, New York.

a. Including agriculture within the NZ ETS or any future carbon tax. We believe there is a case for bringing agriculture within the NZ ETS sooner rather than later.

b. Pricing roading taxes taking into account environmental factors as well as transport needs.

c. Broadening roading taxes from ad valorem to include an element of congestion charging.

d. A resource rent tax or royalty on the exploitation of natural resources that are not currently subject to royalties, such as water.

e. Considering how the Group's preferred principles for environmental taxation apply to water quality and usage.

The time to act is now

The mass of scientific evidence shows our climate is changing, with carbon emissions the single biggest cause.

The Government has committed to a target of a net zero emissions economy by 2050 under a Zero Carbon Act, a Green Investment Fund, a Provincial Growth Fund and an independent Climate Change Commission. Should tax reform complement these initiatives?

New Zealand's environmental issues

"In this summer of 2017-18 there can surely be little argument that the effects of global warming are already with us. To think otherwise is probably to belong to a small, but not select, group of people who believe Elvis is alive and well and has changed his name to Donald Trump.[47]*"*

As stated in the Paper, New Zealand's economy and the wellbeing of New Zealanders are heavily dependent on protecting our natural capital base. However, this natural capital base is under pressure[48]. While trading on our "100% Pure New Zealand" image, New Zealand faces numerous environmental challenges, including but by no means limited to:

- Greenhouse gas emissions, particularly from agriculture.
- Our roading-based transport system, with an aging emissions-heavy vehicle fleet.
- Freshwater pollution and over-allocation of water.
- Plastic pollution.
- Pressures on land use, housing and infrastructure from population growth.

New Zealand currently adopts a light touch when it comes to environmental taxation. Like many other OECD countries, our taxes continue to be poorly aligned with the costs of our economic footprint on the environment and climate[49].

We don't think environmental taxes should be relied on as major revenue raisers[50]. By definition, if they succeed in changing behaviour, the direct revenue raised will be small. Nevertheless, at 1.3% of GDP New Zealand's revenue from environmentally related taxes is among the lowest in the OECD[51].

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[47] Hon Sir Michael Cullen, Chair Tax Working Group *Purpose, principles, and possibilities: The Tax Working Group*, Speech to the New Zealand International Fiscal Association (IFA) Conference, Queenstown, 2 March 2018.

[48] Tax Working Group (March 2018), *Future of Tax: Submissions Background Paper. New Zealand Parliamentary Press, Wellington* 40.

[49] OECD (2018), *Taxing Energy Use 2018: Companion to the Taxing Energy Use Database*, OECD publishing, Paris http://dx.doi.org/10.1787/9789264289635-en (as at 19 April 2018).

[50] Supported by *Dimensions of Tax Design*, Vol. 1 of the Mirrlees Review (September 2010), Oxford University Press: Ch. 5 *Environmental Taxes* by Don Fullerton, Andrew Leicester, and Stephen Smith, https://www.ifs.org.uk/publications/mirrleesreview/ (as at 19 April 2018).

[51] OECD Environmental Statistics Database (OECD average is 1.6%). See https://www.oecd-ilibrary.org/environment/data/oecd-environment-statistics/environmental-policy-instruments_data-00696-en?parentId=http%3A%2F%2Finstance.metastore.ing

Environmental taxes should be part of the response

Environmental issues generally require collective action, usually led by government. There is no market incentive for consumers and business to take into account environmental damage, since its impact is spread across many people with little or no direct cost to the polluter[52].

Environmental taxes are by no means the only way for government to respond to environmental issues, nor should they be the only response. However, we believe environmental taxes are an essential part of the Government's toolkit and can play a key role in delivering positive environmental and ecological outcomes in both the medium and long term.

The Government will no doubt develop a clear set of environmental outcomes it wants to pursue both socially and environmentally. Establishing desired outcomes will enable a clear path to investigate whether tax mechanisms are the best option to achieve those outcomes. In some instances a straight elimination of a social-ill could be more appropriate than placing a tax on it.

The OECD has recommended New Zealand expands the use of environmentally related taxes, charges and prices, possibly within the framework of an overall reform of the tax structure with a view to encouraging more efficient use of energy and resources[53].

Living Standards Framework

The Paper states that "the ultimate purpose of public policy is to improve the wellbeing and living standards of New Zealanders"[54]. Treasury's *Living Standards Framework* identifies four capital stocks as being crucial to intergenerational wellbeing: natural capital, social capital, human capital and financial/physical capital[55].

In our view, environmental taxation can contribute to each of the various capitals – notably natural, but also human (the environment plays a part in the physical and mental health of New Zealanders) and, in the medium term, social and financial (provided the environmental taxes are efficiently designed).

Burden of proof

In 2001, the McLeod review noted:

"Our view is that the appropriate burden of proof on those advocating eco-taxes should be identical to the burden placed on those seeking concessionary tax treatment for particular activities or sectors. We consider the initial presumption should always be against the introduction of selective taxes."[56]

While we agree with the logic of this test, climate change and environmental issues are now more prominent and urgent and we believe there is a stronger case for examining environmental taxes than in 2001.

Environmental taxation faces challenges

Recently, Hon Sir Michael Cullen committed, in his own words, the "ultimate heresy" in putting forward the notion that a particular tax being distortionary might be a good, not a bad, thing[57].

The case for using taxes to help achieve environmental goals rests on efficiency. Can tax reform achieve a given level of environmental protection at lower cost than non-tax alternatives such as trading schemes or regulation? Will the tax change behaviour for the public good?

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enta.com%2Fcontent%2Fthematicgrouping%2Fd77d7b93-en (as at 19 April 2018).

[52] OECD (2010) *Environmental Taxation – A Guide for Policy Makers* (September 2011), based on the OECD's book *Taxation, Innovation and the Environment* (October 2010).

[53] OECD Environmental Performance Reviews: New Zealand 2017. See http://www.oecd.org/newzealand/oecd-environmental-performance-reviews-new-zealand-2017-9789264268203-en.htm (as at 19 April 2018).

[54] Tax Working Group (2018), *Future of Tax: Submissions Background Paper*.17.

[55] Treasury (2018), *Living Standards New Zealand*, sourced at 17 April 2018 from: https://treasury.govt.nz/information-and-services/nz-economy/living-standards-0 (

[56] Treasury (2001), *Issues Paper – Tax Review 2001* New Zealand Treasury, Wellington.

[57] Hon Sir Michael Cullen, Chair Tax Working Group *Purpose, principles, and possibilities: The Tax Working Group*, Speech to the New Zealand International Fiscal Association (IFA) Conference, Queenstown, 2 March 2018.

Environmental taxes have difficulties. They can foster inefficient avoidance activities, such as increasing emissions to purchase fuel at a lower cost outside the Auckland area. They can often be equivalent to consumption taxes with regressive consequences, requiring compensation for vulnerable groups.

Environmental taxes also raise challenging questions and intergenerational issues, such as whether current polluters should incur the cost of any future financial loss being caused by their activity, and whether they should also pay for a possible loss in New Zealanders future quality of life.

They tend to work well when wide-ranging changes in behaviour are needed across a large number of businesses and individuals[58].

Given the global nature of climate change, and the insignificant impact that could be made by unilateral action, coordinated international action will be important[59].

The design of environmental taxes is one of the crucial determinants of their overall success[60]. We set out some suggested design elements below.

Benefits of a well-designed environmental tax

As recognised by the OECD[61], taxes can directly address the failure of markets to take environmental impacts into account by incorporating environmental impacts into prices. Changing prices in this way provides consumers and business with flexibility to determine how best to reduce their environmental "footprint". This flexibility[62]:

- Enables lowest-cost solutions – consumers and business decide how to change their behaviour, with market forces determining the lowest-cost way to reduce environmental damage.
- Encourages innovation – the cost to a polluter of generating pollution is increased, which incentivises business to develop new innovations and adapt existing ones.
- Reduces the need for the Government to "pick winners".
- Provides an ongoing incentive to abate at all levels of emissions, unlike a target or technology-based regulation which provides no incentive to abate once the target or standard is met.
- Improves competitiveness of low-emission alternatives, for example public transport and cycling in the case of vehicle fuel taxes.

What makes a successful environmental tax?

To lead to improved outcomes, an environmental tax must:

- Change the price of the affected item to reflect the cost of the environmental harm that it imposes on others[63], and
- Lead to a change in behaviour – either lesser consumption of environmental "bads", such as fuel, or greater consumption of environmental "goods", such as reforestation.

For the tax to be truly effective, there needs to be[64]:

- A comparable degree of environmental damage from the consumption of each taxed item across the tax base,

[58] Supported by *Dimensions of Tax Design*, Vol. 1 of the Mirrlees Review (September 2010), Oxford University Press: Ch. 5 *Environmental Taxes* by Don Fullerton, Andrew Leicester, and Stephen Smith, https://www.ifs.org.uk/publications/mirrleesreview/ (as at 19 April 2018).
[59] See *Dimensions of Tax Design*, Vol. 1 of the Mirrlees Review (September 2010), Oxford University Press: Ch. 5 *Environmental Taxes* by Don Fullerton, Andrew Leicester, and Stephen Smith, https://www.ifs.org.uk/publications/mirrleesreview/ (as at 19 April 2018).
[60] OECD *Environmental Taxation – A Guide for Policy Makers* (September 2011), based on the OECD's book *Taxation, Innovation and the Environment* (October 2010).
[61] Ibid.
[62] Ibid.
[63] Ibid.
[64] These three principals are supported by the McLeod review – see Treasury, Issues Paper – Tax Review 2001 (June 2001).

- The ability to measure consumption – either directly or by proxy, and
- An assessment of the marginal damage caused by consumption.

Designing environmental taxes

The OECD suggests the following design elements[65]:

- Environmental tax bases should be targeted to the pollutant or polluting behaviour, with few (if any) exceptions.
- The scope of an environmental tax should ideally be as broad as the scope of the environmental damage.
    - For example, greenhouse gas emissions from one location contribute to climate change on a global basis – greenhouse gas emissions would therefore ideally be addressed by a global tax.
- The tax rate should be commensurate with the environmental damage.
    - The rate should generally be set to reflect society's value of the environmental damage, other negative spill-over effects of the activity, and the need to raise public revenue.
- The tax must be credible and its rate predictable in order to motivate environmental improvements.
    - Well-designed taxes are highly transparent – it is generally clear what is taxed, who is being taxed, and what the cost to polluters will be per unit of pollution generated.
- Environmental tax revenues can assist fiscal consolidation or help to reduce other taxes.
    - We place little weight on this comment because, as previously noted, if environmental taxes succeed in changing behaviour, direct revenue raised will be small.
- Distributional concerns, for example the possibility of certain taxes having a significant impact on low-income households, should generally be addressed outside the tax through other policy instruments to preserve the incentive effect of the tax.
- Competitiveness concerns need to be carefully assessed. Ideally taxes should not be adapted for competitiveness reasons as other more suitable instruments are available for providing compensation without compromising effectiveness[66]. Responses could include:
    - International co-ordination to reduce gains from relocation.
    - A transitional period to allow affected firms to undertake mitigation measures.
    - Recycling revenues to affected firms (on a basis different from the collection).
- Clear communication is critical to public acceptance.
    - The utilisation of independent green tax reform commissions can help to ensure the policy prescriptions are perceived as credible and not as politically driven.
- Environmental taxes may need to be combined with other policy instruments to address certain issues.

Having outlined some design elements for the Group's consideration, we now turn to some specific considerations relating to what we consider to be two of the largest environmental issues in New Zealand: greenhouse gas and agricultural emissions, and issues around roading and transport. We also discuss the possibility of a resource rent tax or royalties on certain natural resources (water in particular), followed by some other options the Group may wish to consider.

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[65] OECD (2011) Environmental Taxation – A Guide for Policy Makers, (September 2011), based on the OECD's book Taxation, Innovation and the Environment (October 2010).

[66] OECD (2018), *Taxing Energy Use 2018: Companion to the Taxing Energy Use Database*, OECD publishing, Paris

Greenhouse gas emissions

According to the OECD, New Zealand's greenhouse gas gross emissions increased by 6% from 2000 - 2014, while decreasing by 5% in the OECD as a whole.[67] Emissions per capita and per unit of gross domestic product (GDP) are among the top five in the OECD.

New Zealand's Emissions Trading Scheme ("NZ ETS") is the Government's principal policy response to climate change. The objective of the NZ ETS is to support and encourage global efforts to reduce greenhouse gas emissions by[68]:

- Assisting New Zealand to meet its international obligations, and
- Reducing New Zealand's net emissions below business as usual levels.

While we believe the NZ ETS is the right instrument for addressing emissions issues, the emissions issue is of such magnitude that the Group should consider tax reform as part of the toolkit for New Zealand's response.

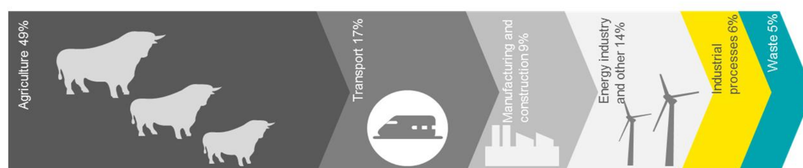
Greenhouse gas emissions are different to more localised issues such as water use, as emissions from one location contribute to climate change on a global basis. Given the relatively small size of New Zealand, action taken to reduce greenhouse gas emissions in New Zealand alone is very unlikely to have a significant impact on the level of global emissions.

The emissions issue would therefore ideally be addressed by global cooperation. However, despite New Zealand's limited ability to impact global emissions levels, New Zealand should take action as early as possible to lead by example and encourage other countries to do the same. There is a question whether the NZ ETS should return to allowing the use of international emissions credits, which may be of dubious provenance.

Agriculture greenhouse gas emissions

The composition of New Zealand's greenhouse gas emissions is unusual, with agricultural emissions dominant:

Half of New Zealand's GHG emissions come from agriculture
GHG emissions by sector, 2014



Note: Excluding emissions/removals from land use, land-use change and forestry.
Source: "Greenhouse gas emissions by source" OECD Environment Statistics (database)

New Zealand has committed to reducing net emissions by 30% below 2005 levels by 2030 under the Paris Climate Change Agreement ("Paris Agreement"), and the Government has announced it will develop a new emissions target of net zero emissions for 2050[69].

Due to the amount of emissions coming from the agriculture sector, where emissions-reduction options are limited, New Zealand may face higher costs than other countries to meet its emissions reduction targets[70]. It has been suggested the cost to the economy of buying international carbon units to offset our own emissions will be $14.2 billion over 10 years[71]. Taking action to reduce climate pollution could reduce the cost to the New Zealand economy of meeting Paris Agreement targets.

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[67] OECD Environmental Performance Reviews: New Zealand 2017. See http://www.oecd.org/newzealand/oecd-environmental-performance-reviews-new-zealand-2017-9789264268203-en.htm (as at 19 April 2018).

[68] Ministry for the Environment (2018), *reducing greenhouse gas emissions*, sourced at 19 April 2018 from: http://www.mfe.govt.nz/climate-change/reducing-greenhouse-gas-emissions/about-nz-emissions-trading-scheme

[69] Tax Working Group (March 2018),, *Future of Tax: Submissions Background Paper*, New Zealand Parliamentary Press, Wellington. 14.

[70] Hon David Parker, Minister for the Environment, Economic Growth within Environmental Limits, Address to the Resource Management Law Association Seminar, Auckland, 28 March 2018. See https://www.beehive.govt.nz/speech/economic-growth-within-environmental-limits..

[71] See http://www.newshub.co.nz/home/politics/2017/05/new-zealand-to-spend-14-billion-to-meet-paris-agreement-targets.html (as at 19 April 2018).

Although agricultural emissions make up around half of New Zealand's greenhouse gas emissions, agricultural emissions are currently excluded from the NZ ETS. The treatment of agricultural emissions has been flagged as an initial area of focus for Government's recently announced Climate Change Commission[72], and the Government is assessing whether to phase agriculture into the NZ ETS over a transition period[73].

Westpac NZ report

A recent report commissioned by Westpac NZ[74] analyses two modelled economic scenarios for New Zealand out to 2050:

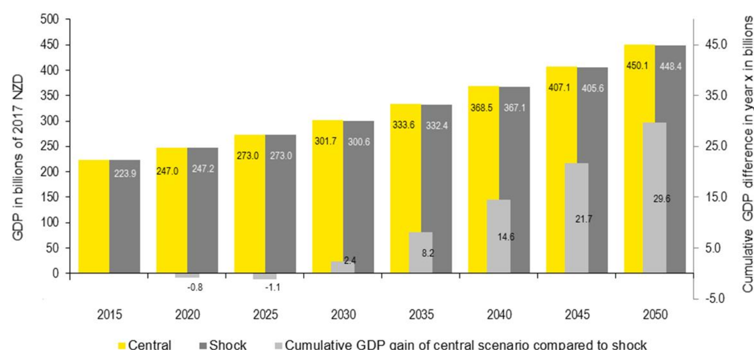
1. A smooth "central scenario" where New Zealand takes early and planned action to reducing greenhouse gas emissions, and
2. A "shock scenario", where New Zealand delays action on climate change until 2030, when it's forced to take more aggressive action to reduce emissions in a shorter timeframe.

The most significant difference between the two scenarios is the timing of the agriculture sector's inclusion in the NZ ETS. Agriculture's faster phase-in into the NZ ETS in 2030 is the "shock" in the "shock scenario".

The report finds that earlier, planned action on climate change under the "central scenario" is modelled to save $30 billion in GDP growth by 2050 compared with the "shock scenario" and results in a 32% lower greenhouse gas emissions price by 2050.

Both scenarios would achieve net zero greenhouse gas emissions in the second half of the century. However, the Government is pursuing a more ambitious target of net zero emissions by 2050.[75] The graph below shows the relative performance of the shock scenario compared with the central scenario:

GDP in the central and shock scenarios and



the cumulative difference

The report also finds that agriculture faces challenges under both scenarios but benefits from an early and phased introduction into the NZ ETS, rather than a more rapid entry later on in 2030. Agricultural sectors are ultimately better able to manage their economic impacts through a longer, better signalled transition period within the central scenario.

What should be done?

The OECD has previously stated that New Zealand needs to reassess its decision to indefinitely postpone the entry of biological emissions from agriculture into the NZ ETS[76]. Based on the evidence outlined above, we believe there is a case for bringing agriculture into the NZ ETS or any future carbon tax sooner rather than later.

The OECD has stated that if agriculture is not brought into the NZ ETS, alternative pricing or regulatory measures should make agriculture contribute to achieving climate mitigation objectives[77].

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[72] *Future of Tax: Submissions Background Paper*. At 15.
[73] Westpac NZ (April 2018), *Climate Change Impact Report*, based on research carried out by EY and Vivid Economics https://www.westpac.co.nz/assets/Sustainability/Westpac-NZ-Climate-Change-Impact-Report.pdf (as at 19 April 2018).
[74] *Climate Change Impact*.
[75] Hon David Parker, Minister for the Environment, *Economic Growth within Environmental Limits*, Address to the Resource Management Law Association Seminar, Auckland, 28 March 2018. See https://www.beehive.govt.nz/speech/economic-growth-within-environmental-limits.
[76] OECD Environmental Performance Reviews: New Zealand 2017. See http://www.oecd.org/newzealand/oecd-environmental-performance-reviews-new-zealand-2017-9789264268203-en.htm (as at 19 April 2018).
[77] Ibid.

Transport system – taxing our vehicle fleet?

While agriculture is New Zealand's largest emissions sector, one of the largest increases in emissions since 1990 has been in road and transport[78]. Seventeen percent of emissions production in New Zealand is from transport[79]. We have one of the highest rates of motor vehicle ownership in the OECD[80]. The number of vehicles has increased by 65% since 2000, with a rising share of diesel vehicles and an average fleet age touching 14 years[81]. Our fleet is highly emission-intensive[82].

New Zealand is the only OECD country to apply an excise duty only on petrol, with diesel vehicles subject to a distance based road user charge instead[83]. Given its current roading rather than environmental focus, merits of the current road user charge include the exclusion of boats and other machinery which do not impact on road use. Disadvantages of this unique approach include[84]:

- Apart from a weight based component, the road user charge doesn't encourage behaviours that would reduce fuel use[85] and
- Diesel vehicles tend to be favoured by the differential charging system due to their higher fuel efficiency. Higher emissions of local air pollutants from such vehicles are not taken into account.

In addition, the tax and charge rates are based on roading infrastructure needs rather than on environmental externalities[86]. For example, the largest external cost of motoring comes from congestion, yet existing taxes are based on fuel purchases[87] and distance travelled. Significant gains could be made by a more precisely targeted structure of economic instruments[88].

While car users respond to increased fuel taxes by driving less, they also invest more in fuel economy which does not reduce congestion – to allow for better congestion management and also anticipating a possible eventual decarbonisation of road transport, it might be better to argue for more sophisticated congestion pricing than for increasing fuel taxes to reflect average congestion[89].

Developments in technology may affect the traditional base of fuel excise duty as vehicles become more fuel efficient[90]. This development further supports the need to re-consider New Zealand's current approach to taxing our transport system.

The Group should explore the following options in further detail:

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[78] *Our Atmosphere and Climate 2017*, Source: Ministry for the Environment, Stats NZ, and data providers, and licensed by the Ministry for the Environment and Stats NZ for re-use under the Creative Commons Attribution 3.0 New Zealand licence. See http://www.mfe.govt.nz/sites/default/files/media/media/our-atmosphere-and-climate-2017-final.pdf (as at 19 April 2018).
[79] OECD Environmental Statistics Database, https://www.oecd-ilibrary.org/environment/data/oecd-environment-statistics_env-data-en (as at 19 April 2018).
[80] OECD Environmental Performance Reviews: New Zealand 2017. See http://www.oecd.org/newzealand/oecd-environmental-performance-reviews-new-zealand-2017-9789264268203-en.htm (as at 19 April 2018).
[81] Ibid.
[82] Ibid.
[83] Ibid.
[84] Ibid.
[85] See also OECD (2018), *Taxing Energy Use 2018: Companion to the Taxing Energy Use Database*, OECD publishing, Paris http://dx.doi.org/10.1787/9789264289635-en (as at 19 April 2018).
[86] OECD Environmental Performance Reviews: New Zealand 2017. See http://www.oecd.org/newzealand/oecd-environmental-performance-reviews-new-zealand-2017-9789264268203-en.htm (as at 19 April 2018).
[87] See *Dimensions of Tax Design*, Vol. 1 of the Mirrlees Review (September 2010), Oxford University Press: Ch. 5 *Environmental Taxes* by Don Fullerton, Andrew Leicester, and Stephen Smith, https://www.ifs.org.uk/publications/mirrleesreview/ (as at 19 April 2018).
[88] Ibid.
[89] OECD (2018), *Taxing Energy Use 2018: Companion to the Taxing Energy Use Database*, OECD publishing, Paris http://dx.doi.org/10.1787/9789264289635-en (as at 19 April 2018).
[90] Tax Working Group, *Future of Tax: Submissions Background Paper* (March 2018), p12.

- Should the Government introduce an excise duty on diesel, as recommended by the OECD[91]?
- Could the tax mix be changed to impose fleet taxes and/or registration taxes based on factors such as greenhouse gas emissions, noise and congestion?
- Should a car's weight, age or engine size affect road charges?
- Should road pricing (tolls or congestion charges) be introduced? The OECD believes road pricing would help improve transport demand management in large urban areas, especially Auckland[92].

Resource rent taxes?

New Zealand currently imposes royalties on the extraction of certain natural resources to ensure the public gets a fair share of any profits generated. The royalties usually try to capture the profit generated by a miner over and above a reasonable economic return (the "rent") and are generally a percentage of either the revenue or profit generated by a miner. An alternative approach is a resource rent tax, which attempts to estimate the rent generated by a miner and directly apply a tax to that rent[93].

The Government has banned new offshore oil and gas exploration but will allow 22 active offshore permits to run until their expiration, which is as far out as 2030.[94] The exploitation of various natural resources, most notably water, is currently not subject to royalties or any form of resource rent tax. Should royalties or a resource rent tax be imposed on the exploitation of these natural resources?

In particular, New Zealand faces several challenges around freshwater pollution and over-allocation of water. Water contamination from the cumulative effects of diffuse agricultural and urban storm water run-off is a growing environmental and public health concern[95]. Water demand in some regions is exceeding what is available and sustainable[96].

The options of a royalty or resource rent tax, water taxes / pollution charges or water quality trading should be considered in further detail. These options may have the potential to internalise the environmental and opportunity costs to diffuse pollution from rural and urban sources and promote innovation in pollution control[97].

Other options for consideration

In addition to the points raised above, other possible environmental taxes the Group may wish to explore could include:

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[91] The OECD recommends New Zealand considers introducing an excise duty on diesel: OECD Environmental Performance Reviews: New Zealand 2017. See http://www.oecd.org/newzealand/oecd-environmental-performance-reviews-new-zealand-2017-9789264268203-en.htm (as at 19 April 2018).

[92] OECD Environmental Performance Reviews: New Zealand 2017. See http://www.oecd.org/newzealand/oecd-environmental-performance-reviews-new-zealand-2017-9789264268203-en.htm (as at 19 April 2018).

[93] *Future of Tax: Submissions Background Paper*.41.

[94] Rt Hon Jacinda Ardern, *Planning for the future - no new offshore oil and gas exploration permits* (12 April 2018). See https://www.beehive.govt.nz/release/planning-future-no-new-offshore-oil-and-gas-exploration-permits.

[95] OECD Environmental Performance Reviews: New Zealand 2017. See http://www.oecd.org/newzealand/oecd-environmental-performance-reviews-new-zealand-2017-9789264268203-en.htm (as at 19 April 2018).

[96] Ibid.

[97] Ibid.

Type of tax	Examples
Product taxes	► Batteries, lighting and other non-green products.
Energy taxes	► Oil, coal and natural gas taxes.
Other fuel taxes	► In addition to the transport issues raised above, there could be scope for taxes on fuels used for heating and industrial processes so long as the NZ ETS doesn't cap greenhouse gas emissions[98]. ► A key issue identified in a recent OECD report is that input fuels for electricity generation are rarely taxed[99].
Other resource taxes	► Aggregates and gravel, mineral extraction taxes. ► Should a resource rent tax replace the current royalty regime for miners?
Other environmental taxes	► Packaging, waste, noise pollution, industrial air emissions. ► Evidence from the Auckland region indicates that districts applying volume-based charges send nearly half of the waste volume to landfills than districts financing waste management through flat charges included in property taxes[100]. Should quantity or volume based waste charges be imposed at a national level to help minimise waste?
FBT	► Should the scope of FBT be expanded to incentivise the use of electric vehicles?
Consumption tax and rebate	► Through its book *Vanishing Nature*, the Environmental Defence Society has suggested an environmental consumption tax and rebate. The tax would effectively put a price on environmental impacts of intensive land uses, such as biodiversity loss and greenhouse gas production, with land area and intensity of use identified from high-resolution satellite imagery and land title information[101].

Sustainability incentives

Tax incentives can be used to promote activities aligning with environmental objectives. However, as recognised in the Paper, tax incentives can have disadvantages when compared to an environmental tax – they can involve "picking winners" and can be fiscally costly[102].

Nevertheless, the Group may wish to consider the following possible tax incentive options:

Type of incentive	Key points / examples
Tax deductions	► Should further accelerated deductions be introduced in addition to the existing accelerated deductions for forestry capital costs and certain types of environmental expenditures? For example, should there be accelerated depreciation for energy-efficient and renewable energy property?
Property tax abatements	► Should there be property tax abatements from subnational jurisdictions for renewable energy property and infrastructure?
Reduced excise taxes	► On alternative fuels and fuelling infrastructure, to encourage increased use of more environmentally friendly forms of transport.
Exemptions for electric vehicles	► Electric vehicles are exempted from road user charges until they make up 2% of the light vehicle fleet. Should this exemption be extended?

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[98] Ibid.
[99] OECD (2018), *Taxing Energy Use 2018: Companion to the Taxing Energy Use Database*, OECD publishing, Paris http://dx.doi.org/10.1787/9789264289635-en (as at 19 April 2018).
[100] OECD Environmental Performance Reviews: New Zealand 2017. See http://www.oecd.org/newzealand/oecd-environmental-performance-reviews-new-zealand-2017-9789264268203-en.htm (as at 19 April 2018).
[101] See http://www.nzherald.co.nz/nz/news/article.cfm?c_id=1&objectid=11468922 (as at 19 April 2018).
[102] Tax Working Group, *Future of Tax: Submissions Background Paper* (March 2018), p49.

Type of incentive	Key points / examples
Grants	► To encourage sustainability investments.
Renewable Energy Credits	► Purchased by companies and energy providers to comply with government regulations requiring certain levels of renewable energy production.
Utility incentives	► From energy providers to encourage energy efficiency as mandated by government regulations.
Feed-in tariffs	► Production-based incentives for renewable energy producers.
Low-interest Government loans	► Allowing organisations to finance renewable energy and energy efficiency projects.

An environmental tax credit?

The Group should also give consideration to environmental tax credits.

As stated by the OECD:

"Innovation plays a critical role in delivering improved environmental outcomes at lower costs. Environmentally related taxes can encourage the development and adoption of market-ready innovations; however, the breakthrough technologies that will lead to fundamental environmental improvements are less likely to be developed under a tax-only regime than under a regime that includes particular incentives for research and development[103]."

New Zealand has a strong background when it comes to environmental related research and innovation, with particular achievements in renewable energy, water pollution and wastewater management and agricultural research.

With the Government already committed to re-introducing a tax incentive for R&D, can the new credit be used to boost environmental related research even further? Could the Government provide tax incentives for investments in, or production from, renewable and alternative energy assets? An enhanced environmental tax credit could be effective, giving businesses the space they need to make decisions without any second guessing by the Government.

Making the most of technology

Tax systems are changing fast. Technology may be the game changer that gives Sir Michael's "heresy" more support. Advances in technology, including artificial intelligence and robotics, can enable the collection of a high volume of sophisticated data that can be analysed in real time.

Technological advancements provide a better chance of designing and administering a smart, targeted tax intervention targeted at changing behaviour and provide a much stronger case for re-examining the longstanding existing broad-based, low rates tax system.

As already mentioned, the case for using taxes to help achieve environmental goals rests on efficiency. One way of achieving efficiency is by ensuring producers and consumers face the social costs of their activities. Can we use technology to approximate the social costs of an activity? For example, can we use technology to estimate the social costs of traffic congestion and then impose a tax on traffic congestion which reflects the social cost?

A hypothetical solution may be using technology to find out how many plastic bottles are being produced, who is producing them, who they are being used by and what proportion are being recycled. Any tax instrument in relation to pollution from plastic bottles can then be targeted based on an informative string of data.

Fringe benefit tax on motor vehicles, currently calculated based on the value of the vehicle, provides another example. Smart use of

[103] OECD (September 2011), *Environmental Taxation – A Guide for Policy Makers* based on the OECD's book *Taxation, Innovation and the Environment* (October 2010).

emissions monitoring technology could easily change that to taxing on the level of pollution caused, potentially in real time.

Hypothecation

In 2012-15, the National Land Transport Fund (which receives all revenue from the petrol excise duty and road user charge) mostly financed investment in highways and local roads – public transport, cycling and walking infrastructure received only 10% of the fund[104]. Could technology be used to enable hypothecation in the area of environmental tax, such that tax revenues are allocated to environmental spending objectives?

Any such hypothecation would need to be done in a way that does not limit Government spending on environmental matters to the tax revenue received.

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[104] NZTA, 2015 – see OECD Environmental Performance Reviews: New Zealand 2017, http://www.oecd.org/newzealand/oecd-environmental-performance-reviews-new-zealand-2017-9789264268203-en.htm (as at 19 April 2018).

Chapter 5

5. Capital taxation

"…Taxes are among the most effective tools governments have for reducing inequalities and bringing about more inclusive growth"[105].

Snapshot

The current level of wealth inequality challenges the concept of inclusive growth. It is much more concentrated than income inequality. It adversely affects social and human capital.

Taxation of capital gains needs to be seen as a part of the overall taxation of capital income and household wealth, not as an isolated issue to address concerns in the housing market.

The overarching tax principles of efficiency, horizontal and vertical equity and coherence all suggest an integrated system of taxing capital income and wealth is required. In our view, the tax system needs to be clearly progressive if it is to be sustainable.

The main potential instruments for capital taxation are capital income taxes, CGTs, capital transfer taxes (such as inheritance or gift taxes) and ownership-based taxes (wealth tax or land tax). Redistribution style taxes need to be balanced against the current over-taxation of certain savings.

Capital income taxation is ripe for reform.

[105] OECD, see http://www.oecd.org/tax/tax-policy/better-design-of-taxes-on-personal-savings-and-wealth-is-needed-to-support-inclusive-growth.htm (as at 20 April 2018).

Recommendations

1. There is a case at the margin for tilting the balance of capital taxation from flows – such as interest and dividends – towards stocks – such as land and other stores of wealth.
2. The impact of the tax system on income and wealth needs to be considered on a holistic basis:
    a. Reconsider the current TTE approach towards taxing private savings.
    b. Move towards taxing real rather than nominal gains.
    c. Investigate the possibilities of wealth taxes and land taxes (noting their potential substitutability and overlap).
3. If the Government has concerns regarding residential investment property, consider reforms targeted to the specific problem.
4. If the Government has concerns regarding all forms of capital investment, consider a broad-based CGT.
5. When designing a CGT:
    a. The best theoretical design would be wide-ranging, on a broad asset base, with an element of accrual taxation. Given the exclusion of the family home and the familiar difficulties with accrual taxation, we are into a "second best" world.
    b. Ideally, tax should be imposed on real rather than nominal gains.
6. We accept that a realisation-based CGT is a much more likely outcome. Design of such a tax should be based on:
    a. Minimising the number of realisation events
    b. Approximating real gains, for example, by way of taper relief
    c. Ring-fencing capital losses
    d. Taxing gains from a valuation day
    e. Minimising exemptions and reliefs
7. We retain doubts regarding the value of a separate CGT given the family home is to be excluded.

Addressing wealth inequality

One of the key criteria by which we should assess our tax system is through equity and fairness. Our current tax system focuses heavily on taxing income. However, income is not the only or major source of affluence for many New Zealanders.

Wealth inequality is much more concentrated than income inequality. When considering the Living Standards Framework, wealth inequality adversely affects both social and human capital. It tends to reduce social cohesion, particularly in relation to trust between different groups in society.

Wealth inequality is an issue in many parts of the world:[106]

The wealthiest 1% of population own 50.1% of all household wealth in the world

[106] According to Credit Suisse Research Institute Global Wealth Report (November 2017).

New Zealand is not exempt from the inequality effect despite our progressive income tax rates.

The Paper attempts to illustrate the level of wealth inequality among households in Figure 17[107]. Figure 17 is based on Statistics New Zealand figures for median household net worth by quintile for the year ended 30 June 2015.

In our view, splitting households into quintiles disguises the extent to which wealth is concentrated. We suspect wealth inequality is more significant than suggested by Figure 17.

Looking at the figures at a more granular level, for the year ended 30 June 2015, the top 10% of New Zealand households accounted for around half of total wealth, while the bottom 40% held only 3% of total wealth[108]. When looking at individuals, the top 10% owned approximately 60% of total net worth, with our wealthiest 1% accounting for approximately 22%[109].

In addition, there is evidence that inhabitants in some developed economies may underestimate the actual extent of wealth inequality in their own country. Research has shown that, on average, Australian adults overestimate the wealth of the poorest quintile by a factor of more than seven, while underestimating the wealth of the wealthiest quintile by more than a fifth[110]. Their American counterparts were prone to similar misperceptions about wealth distribution in the United States[111].

Intergenerational equity

Individual net worth is skewed towards older New Zealanders. Statistics New Zealand figures for the year ended 30 June 2015 show that young people (15–24 years) had the lowest median individual net worth ($1,000) and older people (65+) had the highest ($288,000) [112].

These figures raise issues around intergenerational equity, with a prima facie case that equity would be enhanced should capital stocks (mostly held by older people) bear a greater burden than is currently the case. Increased capital taxation could allow for some reduction of labour income taxation, mostly generated by New Zealanders under 65. On a static lifetime basis, there is no intergenerational inequality and any reform could prove difficult for cash-poor, asset rich older people.

The impact of technology

The inequality debate is not immune from the impact of technology. A small number of entrepreneurs involved in the development of successful new technology may accumulate significant wealth and therefore raise the level of recorded wealth inequality while increasing the wealth of all.

It is important not to discourage entrepreneurial developments, given that technological advancements are likely to be good for the economy and the wellbeing of many New Zealanders. Immigration New Zealand actively seeks such investment under its Investor Plus category[113] given the economic benefits to New Zealand of such investment.

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[107] Tax Working Group, *Future of Tax: Submissions Background Paper* (March 2018), p37.

[108] Statistics New Zealand household net worth statistics for year ended 30 June 2015. See also https://www.stats.govt.nz/news/top-10-percent-of-households-have-half-of-total-net-worth (as at 20 April 2018).

[109] Statistics New Zealand household net worth statistics for year ended 30 June 2015. See https://www.stats.govt.nz/news/top-10-percent-of-households-have-half-of-total-net-worth (as at 20 April 2018).

[110] Michael Norton, David Neal, Cassandra Govan, Dan Ariely and Elise Holland, *The Not-So-Common-Wealth of Australia: Evidence for a Cross-Cultural Desire for a More Equal Distribution of Wealth*, Analyses of Social Issues and Public Policy, Vol. 14, No. 1, 2014, p344. See http://www.hbs.edu/faculty/Publication%20Files/norton%20neal%20govan%20ariely%20holland_9c8b4689-d8f7-43c1-82e3-e85f552caca4.pdf (as at 26 April 2018).

[111] Michael Norton and Dan Ariely, *Building a Better America–One Wealth Quintile at a Time*, Perspectives on Psychological Science 2011 6(1). See http://www.people.hbs.edu/mnorton/norton%20ariely.pdf (as at 26 April 2018).

[112] Statistics New Zealand household net worth statistics for year ended 30 June 2015. See also http://archive.stats.govt.nz/browse_for_stats/people_and_communities/Households/HouseholdNetWorthStatistics_HOTPYeJun15.aspx (as at 20 April 2018).

[113] https://www.immigration.govt.nz/new-zealand-visas/apply-for-a-visa/visa-factsheet/investor-plus-investor-1-resident-visa (as at 26 April 2018).

Holistic approach required

The overarching tax principles of efficiency, horizontal and vertical equity and coherence all suggest an integrated system taxing all capital income and wealth is required. We particularly take that view given we see New Zealand's tax system needs to be clearly progressive if it is to be sustainable.

The extent to which the tax system is currently progressive needs to be considered holistically, taking into account our transfer system and both income and capital taxes. Given exclusions from the Group's Terms of Reference[114], we concentrate our comments on capital taxation.

The main potential instruments for capital taxation are:

- Capital income taxes, notably the taxation of private savings,
- CGTs,
- Capital transfer taxes – such as inheritance or gift taxes, and
- Ownership-based taxes – including other wealth taxes and land tax.

These instruments cannot be used in combination too heavily or capital taxation will compound to very high rates. We discuss each of these areas further below, with the exception of capital transfer taxes since an inheritance tax has been excluded by the Group's Terms of Reference[115].

Taxation of private savings

"Better saved than sorry.[116]"

New Zealand appears to have a private savings problem

New Zealand's approach to the taxation of retirement savings is unique. Our tax system does not offer large concessions for retirement savings[117]. As the Paper states "some commentators think that New Zealand should tax income from capital at a lower rate to encourage more saving, particularly for retirement. New Zealand's lack of concessions for retirement savings is rare among OECD countries[118]."

The current level of savings is likely to be insufficient to support many New Zealanders in their retirement. Despite KiwiSaver and the Government's provision of New Zealand Superannuation ("NZ Super"), it's unlikely that the level of savings is high enough to allow people to retire with a similar lifestyle to what they had during their working days[119]. Most New Zealanders consider about twice the current level of NZ Super is needed for a comfortable retirement[120]. Research conducted for the Financial Services Council last year shows a $218 average after tax weekly gap between what the retired need to live comfortably and what they actually have[121]. Accordingly, there is a strong need

[114] Terms of Reference: Tax Working Group (November 2017), https://taxworkinggroup.govt.nz/resources/terms-reference-tax-working-group (as at 20 April 2018).
[115] Terms of Reference: Tax Working Group (November 2017), https://taxworkinggroup.govt.nz/resources/terms-reference-tax-working-group (as at 20 April 2018).

[116] *Better saved than sorry: The Treasury's position on New Zealand's saving performance*, Speech Delivered by John Whitehead, Secretary to the Treasury on 13 August 2007, https://treasury.govt.nz/publications/speech/better-saved-sorry-%C2%A0treasurys-position-new%C2%A0zealands-saving-performance (as at 24 April 2018).
[117] Tax Working Group, *Future of Tax: Submissions Background Paper* (March 2018), p5.
[118] Tax Working Group, *Future of Tax: Submissions Background Paper* (March 2018), p26.

[119] Savings Working Group, *Saving New Zealand: Reducing Vulnerabilities and Barriers to Growth and Prosperity: Final Report to the Minister of Finance* (January 2011), https://treasury.govt.nz/publications/saving-new-zealand-reducing-vulnerabilities-and-barriers-growth-and-prosperity-final-report-minister (as at 24 April 2018).

[120] Financial Services Council, *The Tax Barrier to Retirement Prosperity in New Zealand* (2013), https://www.fsc.org.nz/site/fsc/files/SuperSize%20Conference%202013/FSC-Taxation%20and%20Savings%20Paper-Final%20copy.pdf (as at 24 April 2018).
[121] *Great Expectations: Retirement Realities for Older New Zealanders*, Research Paper No. 2, Research conducted for the Financial Services Council (December 2017), https://www.fsc.org.nz/site/fsc/Great-Expectations-FINAL.pdf (as at 24 April 2018).

for NZ Super to be supplemented by private savings[122].

A recent OECD report found there is significant scope to improve the way countries tax savings, including taxing savings types more equally to improve both efficiency and fairness[123]. There are clear indications that New Zealanders save less than those in similar countries[124]. New Zealand's tax system is seen as biased towards investment in the property market and against long-term savings such as KiwiSaver and bank term deposits[125]. This bias not only has adverse impacts on retirement savings but may also mean the savings we do have are being put to relatively unproductive use.

New Zealand's savings problem will become even more pertinent over the next decade or so as the population ages and life expectancies increase, calling into question the long-term viability of NZ Super. Intergenerational concerns arise around whether the younger population should face the costs of the ageing population.

In 2011, the Savings Working Group took a strong view of the available evidence. It stated[126]:

> *"New Zealanders – the people and the government – are not saving enough. Unless we make some rapid changes, we are risking a major economic disruption likely to leave practically all New Zealanders worse off. It's as if we are standing on top of a cliff that may collapse dramatically or crumble slowly. Either way, it would be a bad fall. We need to move back from the brink – and fast."*

We acknowledge there are limitations when looking at data and statistics around savings. The policy analysis is difficult because no one set of data provides the ability to draw categorical conclusions[127]. Savings can be measured in many different ways, there are data uncertainties at both a micro / household level and at a macro level[128]. In addition, findings are often dependent on particular assumptions.

Our judgment is the evidence points towards a private savings problem in New Zealand. We believe there is a case for reconsidering the balance between private and public savings and the role of the tax system. Our judgment is based on a least-regrets approach. We agree with the position previously put forward by Treasury that when it comes to savings it is

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[122] Financial Services Council, *The Tax Barrier to Retirement Prosperity in New Zealand* (2013), https://www.fsc.org.nz/site/fsc/files/SuperSize%20Conference%202013/FSC-Taxation%20and%20Savings%20Paper-Final%20copy.pdf (as at 24 April 2018).

[123] OECD (2018), Taxation of Household Savings, OECD Tax Policy Studies, No. 25, OECD Publishing, Paris, http://dx.doi.org/10.1787/9789264289536-en (as at 24 April 2018).

[124] Savings Working Group, *Saving New Zealand: Reducing Vulnerabilities and Barriers to Growth and Prosperity: Final Report to the Minister of Finance* (January 2011), https://treasury.govt.nz/publications/saving-new-zealand-reducing-vulnerabilities-and-barriers-growth-and-prosperity-final-report-minister (as at 24 April 2018). See also *Better saved than sorry: The Treasury's position on New Zealand's saving performance*, Speech Delivered by John Whitehead, Secretary to the Treasury on 13 August 2007, https://treasury.govt.nz/publications/speech/better-saved-sorry-%C2%A0treasurys-position-new%C2%A0zealands-saving-performance (as at 24 April 2018).

[125] Financial Services Council, *The Tax Barrier to Retirement Prosperity in New Zealand* (2013), https://www.fsc.org.nz/site/fsc/files/SuperSize%20Conference%202013/FSC-Taxation%20and%20Savings%20Paper-Final%20copy.pdf (as at 24 April 2018).

[126] Savings Working Group, *Saving New Zealand: Reducing Vulnerabilities and Barriers to Growth and Prosperity: Final Report to the Minister of Finance* (January 2011), https://treasury.govt.nz/publications/saving-new-zealand-reducing-vulnerabilities-and-barriers-growth-and-prosperity-final-report-minister (as at 24 April 2018).

[127] *Better saved than sorry: The Treasury's position on New Zealand's saving performance*, Speech Delivered by John Whitehead, Secretary to the Treasury on 13 August 2007, https://treasury.govt.nz/publications/speech/better-saved-sorry-%C2%A0treasurys-position-new%C2%A0zealands-saving-performance (as at 24 April 2018).

[128] *Better saved than sorry: The Treasury's position on New Zealand's saving performance*, Speech Delivered by John Whitehead, Secretary to the Treasury on 13 August 2007, https://treasury.govt.nz/publications/speech/better-saved-sorry-%C2%A0treasurys-position-new%C2%A0zealands-saving-performance (as at 24 April 2018).

better to take action now than to be sorry later[129].

Current approach

New Zealand currently taxes savings on a TTE basis[130].

In effect the money will be subject to another layer of tax, GST, when it is spent. In comparison, if the income is spent immediately it's only taxed twice – as initial income and when it's spent. This difference discourages saving[131].

While this TTE approach is consistent with a BBLR tax system, many other countries take a different approach. A number of OECD countries take an Exempt-Exempt-Taxed ("EET") approach where tax is imposed only at the withdrawal stage[132]. This EET approach could be partially explained by the fact that social security pensions are subject to means-testing in many countries[133].

Moving towards a fairer TTE system

As stated by the Financial Services Council, common sense calls for change but the tax reform options are not easy[134].

In an ideal system all savings would be taxed to the same extent. The next best alternative is to remove or reduce the bias in the tax system towards investing in the property market as opposed to long-term savings. An ideal system also needs to be sustainable – it should encourage long-term savings where possible, but recognise that some individuals have no or low ability to save.

There are a number of possible reform options available, many of which have already been canvased and explored by others[135]. There is not necessarily one superior option for reform: the best solution could be a combination of options.

Adopting an EET approach is likely to be fiscally costly and would also translate to considerable compliance costs for existing providers. Changes within a TTE system are more manageable. This suggests remaining in a TTE system with a reduced level of taxation both at the contribution stage and the income earning stage.

In particular:

- Reducing the level of taxation at the contribution stage may incentivise some

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[129] *Better saved than sorry: The Treasury's position on New Zealand's saving performance*, Speech Delivered by John Whitehead, Secretary to the Treasury on 13 August 2007, https://treasury.govt.nz/publications/speech/better-saved-sorry-%C2%A0treasurys-position-new%C2%A0zealands-saving-performance (as at 24 April 2018).

[130] New Zealand's "TTE" tax system means
- Contributions are made out of income that is taxed (usually an individual's labour income).
- Income earned from the investment, such as interest and dividends, is taxed (whether earned before or during retirement) though the portfolio investment entity tax rates are available.
- Amounts "withdrawn" from the investment are not taxed.

See Tax Working Group, *Future of Tax: Submissions Background Paper* (March 2018), p26.

[131] Savings Working Group, *Saving New Zealand: Reducing Vulnerabilities and Barriers to Growth and Prosperity: Final Report to the Minister of Finance* (January 2011), https://treasury.govt.nz/publications/saving-new-zealand-reducing-vulnerabilities-and-barriers-growth-and-prosperity-final-report-minister (as at 24 April 2018).

[132] See Tax Working Group, *Future of Tax: Submissions Background Paper* (March 2018), p26.

[133] See Tax Working Group, *Future of Tax: Submissions Background Paper* (March 2018), p26.

[134] Financial Services Council, *The Tax Barrier to Retirement Prosperity in New Zealand* (2013), https://www.fsc.org.nz/site/fsc/files/SuperSize%20Conference%202013/FSC-Taxation%20and%20Savings%20Paper-Final%20copy.pdf (as at 24 April 2018).

[135] See, for example: Financial Services Council, *The Tax Barrier to Retirement Prosperity in New Zealand* (2013), https://www.fsc.org.nz/site/fsc/files/SuperSize%20Conference%202013/FSC-Taxation%20and%20Savings%20Paper-Final%20copy.pdf (as at 24 April 2018); Savings Working Group, *Saving New Zealand: Reducing Vulnerabilities and Barriers to Growth and Prosperity: Final Report to the Minister of Finance* (January 2011), https://treasury.govt.nz/publications/saving-new-zealand-reducing-vulnerabilities-and-barriers-growth-and-prosperity-final-report-minister (as at 24 April 2018); *Taxation of Savings and Investment Income*, joint report IRD and Treasury (September 2012), http://taxpolicy.ird.govt.nz/publications/2013-other-savings-investment/taxation-savings-and-investment-income (as at 24 April 2018).

individuals to invest their money into saving for retirement.

- Behavioural economics suggests encouragement is required to ensure people act in their own interests. Policies based around nudging or making the preferred behaviour easy are frequently influential. Some people behave in predictable ways, such as hyperbolic discounting of future benefits, which can be corrected through relatively small upfront incentives.
- Consideration should be given to whether a reduction in the level of taxation at the contribution stage should be targeted towards people on lower incomes.
- Reducing the level of taxation at the income earning stage is likely to have a significant positive impact on the level of savings over the longer term. This "middle T" can significantly reduce a person's retirement savings, particularly in relation to long-term or accumulated savings that are reinvested into the savings instrument.

Other options the Group should give further consideration to include:

Compulsory KiwiSaver membership

Compulsory KiwiSaver membership may solve some of the behavioural factors around why people fail to adequately save for retirement. People are often prone to short-term bias, where they prioritise their current needs and desires over long-term ones. There has already been a change in behaviour from requiring people to opt out of KiwiSaver rather than opt in.

However, there are individuals within our society who do not have the capacity to make KiwiSaver contributions without a noticeable decrease in their current quality of life. Accordingly, we believe it would be worthwhile considering whether KiwiSaver should be made compulsory only for those earning over a certain income threshold.

Concessionary tax treatment for investment in PIEs

PIEs and other similar investment vehicles are beneficial to the economy and should be supported. They are managed by professional fund managers who have greater knowledge around investment decisions and greater accountability to investors. Professional fund managers are also more likely to invest in a diverse range of different risk investments, whereas individual investors are more likely to be risk averse. The collective nature of such investment vehicles means investors are more insulated against those risks on a collective basis.

Consideration should be given to lowering prescribed investor rates for PIE funds and locked-in savings such as KiwiSaver and similar schemes. If New Zealand introduces a CGT, concessionary treatment for gains made by PIEs should be retained.

Specific support for people on low incomes

It should come as no surprise that inadequate retirement saving affects a higher proportion of people on low to middle incomes[136].

People who are on low incomes are already subject to relatively low taxation on the "middle T". However, thought should be given as to how the level of taxation on the "middle T" can be reduced further for those on low incomes, such as taxing only a fraction of the total income earned from the investment. Other options could include a lower tax rate on contributions to savings accounts, or a "top up" for those who save above a certain portion of their income.

Real vs. nominal gains

In our view, a significant issue that needs to be addressed is whether tax should be levied on a real or nominal basis.

The starting point of any tax is that it should only be levied on real gains, not nominal gains – meaning there is no taxation of gains solely

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[136] *Better saved than sorry: The Treasury's position on New Zealand's saving performance*, Speech Delivered by John Whitehead, Secretary to the Treasury on 13 August 2007, https://treasury.govt.nz/publications/speech/better-saved-sorry-%C2%A0treasurys-position-new%C2%A0zealands-saving-performance (as at 24 April 2018).

attributable to inflation. However, this principle is difficult to apply in practice and most of our tax system currently taxes nominal gains.

We consider taxing nominal gains as opposed to real gains to be problematic, especially in a low interest rate environment. As stated in the Paper, "As nominal income is fully taxed (that is, income including the inflation component), a 33% tax on the nominal return (that is, the real return plus inflation) on savings in a bank account is actually a materially higher tax on the real return[137]."

Example: an effective 100% tax

For example, if an individual has a bank account with an interest rate of 3% per annum and they have deposited a total of $100:

- At the end of the year they will have $103 – a nominal return of $3.
- Assuming an inflation rate of 2%, $2 is inflation and the real return is only $1.
- If the nominal return of $3 is taxed at 33%, the entire $1 real return is taken.

A fairer base would be to tax the real return.

There are a number of options for accounting for inflation,[138] including:

- A risk free return method (an annual inflationary adjustment set at a rate based on real capital returns),
- Taper relief, and
- Indexation.

Decreased tax revenue

Reducing the level of taxation at the first and middle "T's", in combination with the assumption that a reduced level of taxation results in a higher level of private savings, there will be less tax revenue. This decrease in tax revenue may cause NZ Super to become less affordable than it already is. However, an increased level of private savings should reduce the need for public savings in the future.

It is also important to note that increased savings are likely to have a positive flow-on effect for the New Zealand economy as a whole. As stated by the Treasury, "higher saving creates higher income for New Zealand and New Zealanders. It makes more money available for investment in productive assets, and therefore increases our wealth over time[139]."

CGT and the housing market

In New Zealand, the debate around CGT has largely focussed on gains made by investors in the residential property market[140]. While housing availability and affordability is a significant issue, we do not think CGT is the answer.

Is residential rental property under-taxed?

There is evidence to suggest investment in residential rental property is currently under-taxed when compared to other forms of investment or savings[141]. This distortion in the tax system may have encouraged investment away from other areas and into the residential rental property market. However, this evidence is generally highly dependent on

[137] Tax Working Group, *Future of Tax: Submissions Background Paper* (March 2018), p39.

[138] The issues caused by taxing nominal gains as opposed to real gains are even more significant in the context of a CGT on property that has been held for a number of years. This matter, along with the possible options for accounting for inflation, are discussed further below in the context of CGTes.

[139] *Better saved than sorry: The Treasury's position on New Zealand's saving performance*, Speech Delivered by John Whitehead, Secretary to the Treasury on 13 August 2007, https://treasury.govt.nz/publications/speech/better-saved-sorry-%C2%A0treasurys-position-new%C2%A0zealands-saving-performance (as at 24 April 2018).

[140] See, for example: https://thespinoff.co.nz/society/inland-revenue/31-03-2018/why-the-lack-of-a-capital-gains-tax-is-letting-property-companies-off-lightly/; http://www.newshub.co.nz/home/election/2017/07/housing-capital-gains-are-soaring-in-new-zealand.html; and https://www.tvnz.co.nz/one-news/new-zealand/capital-gains-tax-on-investment-property-bold-call-from-reserve-bank-6288439 (as at 20 April 2018).

[141] *A Tax System for New Zealand's Future*: Report of the Victoria University of Wellington Tax Working Group (January 2010).

underlying assumptions and should not be relied upon as the sole reason for introducing a CGT.

For example, Figure 21 of the Paper shows a marginal effective tax rate ("METR") on savings of 29.4% for rental property, which seems low when compared to the next lowest METR of 47.2% for portfolio investment entity, superannuation fund and non-distributing company investments[142]. However, Figure 21 is based on assumptions around what proportion of the return is on rental yield and what proportion represents real capital gain[143]. Changing these assumptions to show a slightly higher rental yield and lower real capital gain would produce a different result. The variability of results is demonstrated by comparing the findings of Figure 21 to a recent OECD study which shows residential rental property to be taxed relatively highly in New Zealand compared to other asset types[144].

Even if residential rental property is under-taxed, many other aspects contribute to housing price inflation

Any under-taxation of capital gains on residential investment properties is unlikely to be the main cause of housing price inflation. A growing population, immigration, internal migration to urban centres, construction skills shortfalls, changing housing expectations, housing regulations and a shortage in the number of new houses being built may all be bigger contributors to the current state of the housing market. The tax system cannot deal with many of these issues.

Even so, there is value in structuring our tax system to ensure incentives to invest are not distorted in a way that favours residential housing.

Is a CGT the best option for addressing housing concerns?

CGTs tend to address wealth inequality by targeting capital which is typically held by high wealth individuals. However, for many New Zealand households a lot of their wealth is tied up in the family home[145]. Accordingly, while a CGT may help to address wealth inequality in some ways, the exemption of the family home means much of that wealth may not be targeted by any potential CGT and limits revenue-raising potential. In fact, a CGT which exempts the family home may encourage individuals to invest more into their family home as an untaxed source of capital.

We acknowledge the practical challenges associated with the family home and also the international precedents as a consequence. One way of addressing concerns regarding the family home while still contributing to a progressive tax system could be to include gains on high-value owner occupied homes, for example, if the proceeds exceeded a certain threshold.

Other options for taxing residential rental property

There are many options available to address the taxation of residential investment property (and other similar property-related transactions), with a CGT being one. However, the scope of a CGT could go far beyond taxing these types of gains. As the debate around CGT has focussed heavily on the housing market, there has been insufficient consideration of other types of gains that might be taxed.

If the Group's view is that New Zealand should tax investment gains in the property market, consideration should be given to more specific, tailored approaches to tax only those particular types of capital gains, such as a risk free return method, discussed below. In addition, as New Zealand is largely a small business economy, a significant source of capital gains exist in business goodwill. Consideration will need to be given as to the extent to which these gains are taxed.

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[142] Tax Working Group, *Future of Tax: Submissions Background Paper* (March 2018), p40.

[143] See Tax Working Group, *Charts and Data - Future of Tax: Submissions Background Paper* (March 2018). Small, but credible, changes to those assumptions – such as a reduced real gain in asset price – could reverse the effect.

[144] OECD (2018), Taxation of Household Savings, OECD Tax Policy Studies, No. 25, OECD Publishing, Paris, http://dx.doi.org/10.1787/9789264289536-en (as at 24 April 2018).

[145] Statistics New Zealand household net worth statistics for year ended 30 June 2015. See also https://www.stats.govt.nz/news/top-10-percent-of-households-have-half-of-total-net-worth (as at 20 April 2018).

Current approach

New Zealand currently taxes real property gains through a series of provisions in subpart CB of the Income Tax Act 2007 ("ITA 2007"). These provisions cover certain types of land-related businesses such as land dealing[146] and land development and subdivision[147]. Other general property transactions are covered by s CB 6 of the ITA 2007, which requires income tax to be paid on gains made on property acquired for the purpose or intention of disposal. In our view, IRD has not sought to apply this test with sufficient rigour, resulting in a perception that residential property gains are untaxed.

The introduction of the "bright-line" test in 2015 has gone some way to providing clear rules that tax gains made on short-term property investments, however the impetus remains on IRD to enforce the law appropriately. The test currently requires income tax to be paid on any gains that arise from residential property disposed of within five years of acquisition, subject to some exemptions[148]. As this test has only applied to interests in land acquired after 1 October 2015[149], it is difficult to evaluate its success in capturing certain types of property transactions or to assess its impact on the housing market.

As is the case with CGT in most overseas jurisdictions, s CB 6 of the ITA 2007 and the bright-line test focus on taxing realised capital gains – i.e. gains which arise at the point of sale (or certain other disposal events). This timing has little effect on the problems faced by New Zealand's housing market and can in fact exacerbate these problems. Many residential investment properties are held by their owners for a significant period of time. The investment can often be seen as a form of retirement savings or used as security against further borrowing. Taxing realised gains provides further encouragement for property investors to defer sale of the property to defer taxation, or to potentially avoid it altogether in the case of a bright-line test. Such deferral impacts the availability of houses for sale and consequently the affordability of houses.

Risk-free rate of return method

Another option for taxing investment in certain capital gains (including in the residential rental property market) was supported by both the McLeod Report in 2001[150] and the Victoria University of Wellington Tax Working Group[151] in 2010. The Report published by the Victoria University of Wellington Tax Working Group states "[t]he majority of the Tax Working Group support detailed consideration of taxing returns from capital invested in residential rental properties on the basis of a deemed notional return calculated using a risk-free rate[152]."

A risk free return method ("RFRM") of taxation on certain capital gains should be considered as a way of targeting issues in the housing market without any of the associated issues of a CGT. We agree with both the McLeod Report and the Victoria University of Wellington Tax Working Group that significant research and analysis would need to be undertaken before such a tax could be implemented[153]. We encourage the Group to consider inviting further submissions on an RFRM-based tax.

An RFRM-based tax seeks to tax the capital gain in an asset's value based on an annual notional rate. The notional rate is calculated based on a risk-free real rate of return - i.e. the rate at which the return would be if the funds had been invested in risk-free government bonds (with an adjustment for inflation). An RFRM-based tax is calculated as follows:

> (Net asset value at start of the year) x (statutory risk-free real rate of return) x (investor's tax rate).

The primary appeal of a RFRM-based tax is that it could address the current distortions in the

[146] Section CB 9 ITA 2007.
[147] Section CB 10 ITA 2007.
[148] Section CB 6A ITA 2007.
[149] Taxation (Bright-Line Test for Residential Land) Act 2015.
[150] Tax Review 2001, Final Paper also known as the "McLeod Report".
[151] *A Tax System for New Zealand's Future*; Report of the Victoria University of Wellington Tax Working Group (January 2010).
[152] *A Tax System for New Zealand's Future*; Report of the Victoria University of Wellington Tax Working Group (January 2010), p11.
[153] McLeod Report, p27; *A Tax System for New Zealand's Future*; Report of the Victoria University of Wellington Tax Working Group (January 2010), p53.

taxation of different investment vehicles and types.[154] Key issues for consideration include:

- The accuracy of the method in taxing gains in the value of capital,
- What assets would be subject to the tax (possibly including commercial property),
- Methods for determining asset value at the start of the year,
- Integration with other aspects of the tax system (including company taxation and the personal tax rate),
- Liquidity issues for taxpayers paying such a tax annually,
- How within year sales or acquisitions of assets should be accounted for, and
- Transitional measures.

We would be happy to make further detailed submissions on a RFRM-based tax on assets, specifically addressing the issues raised above. We recommend the scope of any RFRM-based tax be limited, at least initially, to property transactions (excluding the family home, due to the Group's Terms of Reference). This limitation would specifically seek to solve the current problem of under-taxation of this type of capital without capturing other forms of capital which are already sufficiently taxed.

CGT applying across asset classes

The Government has charged the Group with examining the merits of a system of taxing capital gains on assets more broadly than residential property. The Group therefore seeks comment on detailed CGT design, regardless of the merits of such a tax.

The insert below does not presume we see a broad-based CGT as desirable.

Developing a broad-based CGT

1. Objectives
   a. Revenue raising, progressive targeting of wealth inequality or targeting selected asset classes?
   b. Political sustainability, with which removal of the family home will assist.
2. Revenue
   a. Given New Zealand's already broad income tax, a CGT would be supplementary and marginal in terms of total tax revenues.
   b. Assume a slow build-up of revenues over time.
3. Main design issues
   a. The scope of capital subject to the tax (any exemptions or concessions),
   b. Tax base (if on accrual basis),
   c. Tax base (if on realisation basis),
   d. Realisation events,
   e. How to calculate capital gains / asset bases,
   f. The treatment of capital losses, and
   g. Transitional measures.

[154] *A Tax System for New Zealand's Future*; Report of the Victoria University of Wellington Tax Working Group (January 2010), p52.

We set out a summary of suggested design elements in the table below, followed by further elaboration on these points.

Feature	Design	Comment
Scope / asset base	Real property (excluding the family home), gains on shares, chattels, business goodwill and other intangible property	Broad base supports horizontal and vertical equity
Tax base (if on accrual)	RFRM	Would address distortions in the taxation of different investment types
Tax base (if on realisation)	Nominal gains, on a taper basis	Pragmatic alternative to taxing real gains
Realisation events	Minimise number of realisation events	To reduce complexity and compliance burden
Asset valuations	Use arm's length prices	Likely source of dispute
Capital losses	Ring fence	Risk of selective loss realisation if full offset with income tax losses
Transitional measures	CGT should apply to all assets sold after the effective date	Reduces the need for a complex system of "grand-parenting" provisions

4. Scope

a. A CGT should be designed to maximise simplicity and apply to all forms of capital with relatively few carve-outs or exemptions so as not to distort behaviour. If a CGT is to focus on reducing wealth inequality, it should apply to all forms of capital including real property, personal property, shares, intangibles, collectibles etc.

b. While there may be various public policy reasons to support certain types of exemptions, these are often difficult to apply, exacerbate compliance costs and continue to distort investment behaviours. In a study of CGT in Australia and the UK, complexity was found to be the biggest driver of compliance costs in both countries:

"[i]t is difficult to envisage any other tax where compliance costs will often exceed the tax payable. And yet the majority of UK respondents and nearly 30% of Australian respondents were able to agree that this was often the case with CGT.[155]"

c. Both the UK and Australia have a number of carve-outs including personal property exemptions, roll-over relief, a venture capital exemption in Australia and entrepreneur's relief in the UK.

d. A broad-based CGT, levied on real gains from all classes of capital asset likely to appreciate on an accruals basis, has strong theoretical appeal. Given the exclusion of taxation of the

[155] Evans, *The operating costs of taxing the capital gains of individuals: a comparative study of Australia and the UK, with particular reference to the compliance costs of certain tax design features* (2003).

family home from the Group's Terms of Reference[156], the discussion below concentrates on second-best alternatives.

e. Given our comments above on increasing private retirement savings, the Australasian share exemption for PIEs should be retained and should be extended to cover global shares. (This recognises the fact that with a CGT, the current foreign investment fund regime would need to change).

5. Real vs. nominal gains

   a. As noted above, the starting point of any tax is that it should only be levied on real gains, not nominal gains – meaning there is no taxation of gains which are solely attributable to inflation. However, this principle is extremely difficult to apply in practice and most of our tax system currently taxes only nominal gains.

   b. For the majority of capital income, inflation can be immaterial given that tax is levied relatively close to the time of its derivation over a short period. For assets held over a longer-term, the effects of inflation may be significant necessitating some form of allowance to attempt to minimise the taxation of inflation created gains.

   c. We believe the single biggest CGT design issue is how to account for inflation, particularly on assets held long-term.

6. Inflation. There are several options that can be adopted to account for inflation. Our preferred options, in order of preference, are:

   a. An accrual based CGT, such as the RFRM discussed earlier. This method makes an annual adjustment for inflation which is relatively easy to apply and can be set at a rate based on real returns on capital. We believe this method would most easily and accurately allow for adjustments for the effect of inflation.

   b. Taper relief. Many countries have taper relief systems – where the amount of tax levied on the capital gain decreases or is eliminated if the asset is held for a certain period.

   c. In Australia, assets held for over a year qualify for a partial exemption from CGT (a 50% discount for individuals and trusts and 33.33% for complying superannuation entities).

   d. Holding period thresholds for taper relief vary significant across countries. Australia and the United States have a one year minimum holding period whereas Germany and France have a minimum period of 10 and 30 years respectively.

   e. We recommend a taper-style system with a scale for different rates. For example, an asset held for five years might qualify for a 10% discount CGT rate, and an asset held for 10 years might qualify for a 25% discount CGT rate. Such a scale would allow the taper to more accurately reflect the trend of inflation over time, rather than marking a single point in time and applying the concessionary rate at that point. We would not recommend any discount rate beyond 50% because it is unlikely that inflation would effect a gain to this extent except over a very long time (e.g. 30 years). The taper could be periodically reset approximating to inflation outturns over the holding period.

   f. Indexation. While indexation is likely to be more accurate than a taper relief system, it would also be more complex. Australia previously had an indexation system but this system was replaced in 1999 with tax relief. The UK has also wound back indexation both for individuals and, more recently, companies.

[156] Terms of Reference: Tax Working Group (November 2017), https://taxworkinggroup.govt.nz/resources/terms-reference-tax-working-group (as at 20 April 2018).

7. Accrual vs. realisation basis

    a. All OECD countries with a CGT tax capital gains on realisation[157]. However, an accrual basis may be preferable as realisation based CGTs cause "lock-in" where there are incentives to retain assets to defer taxation. In addition, it can take a long time for steady revenue to arise from a realisation-based capital gains system, making it hard to assess the trade-off with compliance costs.

8. Realisation events

    a. If a realisation-based CGT was to be introduced, we support a system that has relatively few "realisation events" as these are often complex and create a large compliance burden. Looking at CGTs internationally, there are a variety of different definitions of "realisation events". For example, Australia has over 55 separate "CGT events" which can give rise to capital gains or losses. This is in part because of the wide variety of capital assets and transactions which are subject to CGT.

    b. Particular consideration should be given to finding a balance between minimising complex realisation rules and reducing opportunities to subvert the CGT through certain tax structuring activities, for example granting exclusive rights to an asset without transferring actual ownership. Realisation rules will also need to cover a number of other situations, including:

        i. Assets or asset holders leaving New Zealand,

        ii. Different rights to use assets, and

        iii. CGT assets becoming subject to other tax rules such as the trading stock or financial arrangements rules.

9. Calculating capital gains and losses

    a. Most countries with a CGT determine the amount of capital gain or loss by taking the difference between the value of the asset on the date of acquisition and the value on the date of realisation[158], possibly subject to transitional concessions (discussed later).

    b. One of the more significant challenges a CGT will face is how to determine the value of assets at the date of acquisition. Some assets may have a natural cost base, for example assets purchased from a third party, however other assets, such as shares in a privately held company, do not have any clear cost base. For all assets other than listed shares, the opportunity to manipulate value based on the market concerned and the availability of different valuation methods is problematic.

    c. We would expect to see significant valuation activity following the introduction of a CGT, leading to subjective but defensible valuations by taxpayers using specialist resources which may not be available to Inland Revenue. While commercial valuations are a forward-looking measure generally based on the net present value of future cash flows, professional valuers frequently quote a wide range of possible valuations and buyer/seller valuations differ substantially.

10. Treatment of capital losses

    a. We believe any CGT should ring fence losses similar to the system in Australia – i.e. capital losses can only be offset against capital gains and cannot be offset against other forms of

[157] Harding, M. (2013), "Taxation of Dividend, Interest and Capital Gain Income", *OECD Taxation Working Papers*, No. 19, OECD Publishing, Paris, p32. See http://dx.doi.org/10.1787/5k3wh96w246k-en (as at 26 April 2018).
[158] Harding, M. (2013), "Taxation of Dividend, Interest and Capital Gain Income", *OECD Taxation Working Papers*, No. 19, OECD Publishing, Paris, p32. See http://dx.doi.org/10.1787/5k3wh96w246k-en (as at 26 April 2018).

income. Capital losses should be able to be carried forward subject to standard loss continuity rules.

b. Allowing capital losses to be offset against other forms of taxable income would likely lead to tax planning opportunities where individuals try to maximise capital losses to offset against other forms of taxable income, while deferring gains.

11. "Black hole" and feasibility expenditure

a. Implementation of a CGT strengthens the case for ensuring all "black hole" and feasibility expenditure is deductible.

b. An Australian provision that allows a deduction (spread over five years) for capital expenditure not otherwise deductible could be a useful model to follow.

12. Transitional measures. There are two choices for transitioning to a CGT. A CGT could:

a. Apply to any asset sold after the effective date, based on the gain over valuation at the effective date. This approach was adopted by Canada when introducing a CGT, or

b. Apply to any asset acquired after the effective date. This approach was adopted by Australia when introducing a CGT.

c. We prefer the first approach which results in an effective date where all assets are brought within the scope of the CGT. No specific "grandparenting" provisions are required which have been a source of complexity in the Australian system.

d. While this approach could lead to a flurry of activity before the effective date (as taxpayers try to offload capital assets to avoid taxation), we believe this outcome is preferable to a complex system of "grandparenting" provisions and an extended period where many capital assets will remain outside the scope of the CGT. We understand the practical issues with this approach.

Asset-based taxes

Capital income taxation alone doesn't tackle wealth inequality. It is also necessary to consider asset-based taxes.

There are two main forms of asset-based taxes: wealth taxes and land taxes, with land taxes being a subset of wealth taxes. These taxes are considered further below.

Wealth taxes

Globally, net wealth taxes have become unfashionable in practice. In 1990, 12 OECD countries levied net wealth taxes[159]. In 2017, only France, Norway, Spain and Switzerland imposed them (with Iceland having reinstated its wealth tax as a temporary fiscal measure). As of January 2018, France has replaced its net wealth tax with a "real estate wealth tax" on high value immovable property[160].

Nevertheless, the perceptions of high levels of wealth concentration have spurred a renewed interest in the redistributive potential of wealth taxes[161].

Wealth taxes in practice

Wealth taxes can take many forms and overlap with other taxes to the extent to which those other taxes are also imposed on wealth as opposed to flows of income or expenditure.

An accrued CGT is an example of a wealth tax, being a tax on appreciation. Land taxes are

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[159] OECD (2018), *The Role and Design of Net Wealth Taxes in the OECD*, OECD Tax Policy Studies, No. 26, OECD Publishing, Paris, http://dx.doi.org/10.1787/9789264290303-en (as at 26 April 2018).
[160] See http://www.ey.com/gl/en/services/people-advisory-services/hc-alert--france-publishes-2018-finance-bill (as at 26 April 2018).
[161] OECD (2018), *The Role and Design of Net Wealth Taxes in the OECD*, OECD Tax Policy Studies, No. 26, OECD Publishing, Paris, http://dx.doi.org/10.1787/9789264290303-en (as at 26 April 2018).

effectively a wealth tax restricted to stocks of land.

Our comments here centre around wealth tax in the form of an annual tax on net worth. In principle, a wealth tax would apply to the net value of all assets held by an individual – shares, houses, pension funds, beneficial interests in trusts, chattels etc. The Group's Terms of Reference narrow the scope of any potential wealth tax by excluding changes which would apply to the family home[162].

Advantages of wealth taxes

Potential benefits of an annual tax on net worth include:

- Wealth taxes contribute to horizontal and vertical equity, or fairness.
  - Wealth taxes contribute to horizontal equity as they are indifferent to the form in which wealth is held.
  - In terms of vertical equity, wealth is far more concentrated than income – wealth taxes would therefore be strongly progressive, more so than any plausible personal income tax scale.
- Wealth taxes promote efficiency.
  - Given the tax is based on assets held, active income generating use of those assets is encouraged, including potentially disposal to a more productive user.
- Administering the wealth tax also promotes coherence within the tax system.
  - The data required by Inland Revenue to assess the tax should prove useful in administering other parts of the tax system.
- Wealth taxes can encourage a substitution from physical to human capital (assuming human capital will be exempt).
  - As human capital is important for long-term growth, the actual harm of wealth taxes to economic growth may be overstated.
- Where asset values are updated frequently, a net wealth tax effectively functions as a tax on accruals, avoiding the "lock-in effect" promoted by taxation on realisation.

Disadvantages of wealth taxes

Various counter arguments exist:

- New Zealand would become a less attractive place for non-residents to allocate capital.
- Revenue raising potential may be limited.
  - Owner-occupied housing accounts for about 30% of a household's total assets[163]. If the Government decides to introduce a land tax (effectively a wealth tax on a subset of wealth), and if the family home is exempt from any wealth tax, the revenue on offer could be limited.
- Capital is increasingly mobile.
  - Individuals could seek to shift assets outside the scope of IRD's ability to locate them. While tax transparency is increasing, it remains possible that individuals may seek to hide many forms of wealth – whether in the form of cryptocurrencies, precious metals or gemstones, or behind discretionary trusts.
- Valuation may be difficult.
  - For those assets which are disclosed, beyond land and listed investment, valuation would be at best inexact.
- As discussed above, New Zealand is often regarded as having a savings problem. Any meaningful wealth tax would include KiwiSaver and other forms of superannuation – would such a reform be desirable or sustainable?

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[162] Terms of Reference: Tax Working Group (November 2017), https://taxworkinggroup.govt.nz/resources/terms-reference-tax-working-group (as at 20 April 2018).

[163] Statistics New Zealand household net worth statistics for year ended 30 June 2015. See also http://archive.stats.govt.nz/browse_for_stats/people_and_communities/Households/HouseholdNetWorthStatistics_HOTPYeJun15.aspx (as at 20 April 2018).

- Asset allocation issues may arise. For example, if residential property is exempt, that would seem to exacerbate any perceived bias towards investing in housing.
- Individuals with high value assets but low realised income may encounter cash flow issues when paying the tax.
- Individuals who save more while young to consume while older will pay more tax compared to those who spread their income more equally over their lifetimes, resulting in horizontal inequity.

While a potential wealth tax may be worth further investigation as part of a review of New Zealand's system for taxing capital income, the disadvantages outlined above may mean a wealth tax could be impractical for New Zealand at the current time. In particular, a wealth tax is likely to be hard to implement and could send a negative signal to investors.

Land taxes

"When applied uniformly across a broad base, land tax is one of the most efficient means of raising revenue."[164]

Land taxes are essentially a subset of wealth taxes. As with wealth taxes, on balance land taxes promote efficiency – they are likely to increase the efficiency with which land is used. Of the different forms of wealth, land is well-suited to a tax – the stock is fixed and the tax non-distortionary.

Expanding these arguments:

- Land tax has the ability to collect sustainable and substantial amounts of taxation using a low rate, provided there are few exemptions (like in Denmark which collects 1.3% of GDP per year from land tax[165]).
- Revenue can be used to fund other tax rate reductions while using a low broad rate of taxation.
- A land tax will improve the equity and fairness of the current system as property, an investment, will be taxed as other investments are.
- Administration is unlikely to be complex - based on the ability of local councils to levy "rates" based on land or property values – and the costs of administering a land tax are likely to be low in proportion to revenue raised[166].

Implementation will be challenging

Should a land tax be introduced, there are concerns which would need to be resolved prior to introduction. When considering the desirability of a land tax, the Group should focus on how to mitigate the following issues:

- The reaction to past land tax proposals has tended to focus on the ability to pay for individuals and businesses that may be asset rich but cash poor. This impact would most likely be on retirees, Māori authorities and farmers.
- In relation to cash poor farmers, the obligation to pay land tax could reduce the purchase of fertiliser and/or reduce or prevent money being put towards other productive investments. In effect, the promoted efficiency gains may go into reverse for cash-constrained farmers.
- A land tax might not be politically sustainable and could be vulnerable to repeal. Concerns around the political sustainability of a land tax were raised by the Victoria University of Wellington Tax Working Group in 2010[167].

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[164] Australia's Future Tax System: Final Report: Part 1 – Overview – Chapter 6: Land and resource taxes (released in May 2010), http://taxreview.treasury.gov.au/content/FinalReport.aspx?doc=html/publications/papers/Final_Report_Part_1/chapter_6.htm (as at 26 April 2018).

[165] Morgan Foundation, Alex Staples and Geoff Simmons, *Taxing Wealth & Property: What Works? A review of wealth and property taxation around the world* (April 2016), http://morganfoundation.org.nz/wp-content/uploads/2016/04/MF_WealthTaxation_Report.pdf?bcsi_scan_01d939382f6c0b14=0&bcsi_scan_filename=MF_WealthTaxation_Report.pdf (as at 26 April 2018).

[166] Most of these, and other points in this note, were made by the Victoria University of Wellington Tax Working Group or the Morgan Foundation.

[167] *A Tax System for New Zealand's Future*: Report of the Victoria University of Wellington Tax Working Group (January 2010).

- Even if a land tax is not repealed, pressure is likely to build for exemptions which have historically tended to undermine loopholes. Which exemptions are justified?
- It is possible that uncertainty around the longevity and scope of any potential land tax could result in unstable land prices and a reduction in efficiency. A land tax could cause investment decisions to be made based on uncertainty around future rates of return as opposed to current rates of return.
- Land tax is likely to depress land values. By how much? What impact will that have on existing finance secured over land?
- It is possible that depressed land values could delay land development. Cash that could have been used for land development may need to be used to decrease debt levels and smooth equity values.
- Given the likelihood of exemptions, land tax burdens tend to fall on the middle class, as exemptions exclude the poor and the wealthy find loopholes to exploit.
- The introduction of a land tax will put pressure on the accuracy of land valuations.

Revenue raising potential

The Group's Terms of Reference exclude the land under the family home from the ambit of any land tax[168].

While we are not aware of any recent estimates of the total value of New Zealand land, a conservative estimate could be around $500 billion in total, of which perhaps $200 billion is residential owner-occupied land[169].

A 1% per annum land tax, before exclusions beyond the family home, could potentially raise $3 billion per annum. Assuming the land tax would be a deductible expense for income tax purposes, perhaps $2 billion would be realistic. This revenue could be recycled into a range of enhancements to other parts of the tax system and/or go towards managing the impact of the tax on selected individuals.

Possible measures to reduce impact

Cash flow issues could be managed by way of deferral for selected taxpayers until the property is sold (for example, retirees or Māori land). Use-of-money interest could be charged on the deferred amount, perhaps at rates linked to inflation rather than at the standard IRD rate.

Māori land is typically held in perpetuity so deferral could in substance become permanent. Taonga/heritage land assets will particularly need consideration. Furthermore, much of the land held by Māori organisations may either be undeveloped or employed in low yield industries (e.g. forestry).

Rates could be varied based on the class of land. For example, farmland or Māori land could attract a differential rate of tax. Low value land could potentially be excluded entirely to manage equity concerns.

Given the fixed nature of land supply, it would be possible to vary land tax rates by region should this be seen as desirable for regional development or other purposes.

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[168] Terms of Reference: Tax Working Group (November 2017), https://taxworkinggroup.govt.nz/resources/terms-reference-tax-working-group (as at 20 April 2018).

[169] Land tax: Background Paper for Session 3 of the Victoria University of Wellington Tax Working Group, drawing on Fiscal Distribution and Efficiency Impacts of Land and Property Taxes, Coleman Andrew and Arthur Grimes (2009).

Chapter 6

6. GST is New Zealand's most effective tax

"The fact is, in New Zealand, the richest 10% of households spend twice as much on food and six times more on clothing than the bottom 10%. So they pay twice as much GST on food and six times more GST on clothing. Only 15% of the benefit from an exemption on food in New Zealand would have gone to the bottom 20% of households by income."[170]

Snapshot

The GST system is an exemplary revenue raiser. New Zealand captures 97% of GST's potential revenue. The OECD average is 56%.

Taken in isolation, GST is mildly regressive, but GST is not paid in isolation. It forms part of a tax system which is progressive in overall terms.

Recommendations

1. Maintain existing GST base as the case for selective zero rating or lower rating is weak.
2. Address any distributional concerns through other parts of the tax system.

Of all the VAT/GST systems in the OECD New Zealand has the second most efficient model in terms of potential revenue captured (behind Luxembourg)[171]. In the 2016 OECD report on consumption tax trends New Zealand captured 97% of GST's potential revenue[172] – significantly above the next closest country Switzerland (71%) and the OECD average (56%)[173]. In 2017 the Government collected around 20% of its total revenue from GST[174], despite the GST rate being significantly lower than income tax rates.

An efficient and comprehensive tax

This efficiency comes from our long-standing policy of having a comprehensive rate of GST on all goods and services, with very few exceptions. New Zealand's GST system is the most functional element of our overall tax

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[170] Douglas, Sir Roger (2007), *The New Zealand GST Policy Choice and its Political Implications*, GST in Retrospect and Prospect, Thomson Brookers.
[171] OECD (2016), *Consumption Tax Trends 2016: VAT/GST and excise rates, trends and policy issues*, OECD Publishing, Paris. 106.
[172] At 105
[173] At 105
[174] New Zealand Treasury (2017), *Financial Statements of the Government of New Zealand for the year ended 30 June 2017*,New Zealand Treasury, Wellington. 7.

system, altering the scheme with new exceptions should be approached with caution.

Weak case for GST exemptions on particular goods or services

GST is a great tool for revenue-gathering but not for redistributing wealth. Because GST is applied on all goods and services equally there is no variation in tax burden depending on income levels. This has led to suggestions of lowering GST on specific goods and services to give GST a more progressive nature.

One of the more popular subjects for GST reduction is fresh fruit and vegetables. The inefficiencies of lowering GST can be demonstrated through this example:

- Limited benefit to low income consumers: high income earners will typically purchase more fruit and vegetables than lower income earners. This will in fact be the case for virtually all goods and services. As such, while the price of a given vegetable will decrease uniformly, those with higher incomes will see the greatest benefit in terms of money saved.
- Alternative mechanisms would be better targeted: it is also argued the policy incentivises lower income earners to purchase more fruits and vegetables as a result of lower prices. The issue here is one of poor targeting. More effective relief could be provided to lower earners by adjusting income support.
- Inefficient administration and scope creep: from a retailer perspective, additional difficulty compounds the issue of efficiency. Once an exemption has been granted for "fruit and vegetables" it is in the interests of a retailer to classify as many goods as "fruit" or "vegetables" as possible. While something like a bag of potatoes is obviously covered, we can start placing goods along a spectrum of "vegetable". Does a bag of frozen potato wedges count? Should potato fries at fast food restaurants be exempt? There is significant scope to apply exemption to goods that perhaps should not be captured; and the cost of regulating this is likely to be high.

The GST and financial services conundrum

The main GST exemption is the provision of financial services. Banks make money through interest rate spreads. Having higher interest rates on money lent than interest paid from deposits.

For example a bank may lend $100 with an interest rate of 6%. The loan would yield $6. The bank may also offer 1% on deposits, so if an account holder deposited $100, the bank would pay $1. The bank's net interest is $5, though GST cannot currently be applied to that earning. The issue is that there is no explicit transaction that has granted that $5; it is the result of two other transactions that in real terms are completely disconnected.

In theory, it should be possible to overcome this difficulty, but in practice we have yet to see good outcomes. For example:

- Unbundling: some financial institutions have sophisticated activity based costing systems and funds transfer pricing systems which could be developed in future to calculate the value added on each transaction. Widespread implementation of these systems is not currently commonplace however, and attempting to force compliance at present is likely to yield low tax revenue. Research into a similar system in the US reported a yield of only 0.4% more revenue to the IRS[175]. Where the US has a much higher proportion of financial services as part of its GDP.
- Proxy taxes: for example, the IMF floated a Financial Activities Tax in 2010[176]. The tax would proxy GST by taxing the sum of cash-flow profit and remuneration for each tax period. The effect being that a tax is applied to the net financial intake of the financial institution, representing the service they provide. Such a tax would require detailed information about the bank in question, some of which is unlikely to be available. To apply the tax an element of estimation or speculation would

[175] Dimitris Chronopoulos (2016), *Future Issues in Bank Taxation*, University of St Andrews, Fife. 14.

[176] European Commission (2010), *Financial sector taxation*, Taxation papers, Office for Official Publications of the European Communities, Luxembourg. 14.

be needed. Because of the difficulty in creating a fair system in those circumstances we believe that a Financial Activities Tax is difficult to justify at present.

GST as part of a wider progressive tax system

At any given point in time, GST is regressive as individuals who consume a higher proportion of their income are taxed proportionately more as a fraction of that income.

Taking a lifetime basis, the picture changes. Most savings are eventually converted into spending on goods and services. A regressive element remains in that unspent income is not taxed on death.

But GST does not exist inside a vacuum, and is better considered as part of the wider tax system. The combination of our GST, income tax and transfer system is redistributive, and the extent of that redistribution is better managed through its non-GST elements.

Moving away from the current broad GST base comes with significant concerns for efficiency and equity. We recommend it is in New Zealand's best interests to maintain the current system.

GST and managed funds and link to retirement savings

Under this heading of GST, we also wish to add our support to the submissions made by others about the GST treatment of fees charged to managed funds and the flow-on link to retirement savings. As we have noted above, New Zealand has a private savings problem which will not be helped by investors suffering a layer of non-recoverable GST on fees charged to managed funds either directly or indirectly.

Chapter 7

7. Tax reform process improvements required

"No man is an Iland, intire of itselfe; every man is a peece of the Continent, a part of the maine"[177]

Snapshot

For the last 25 years, the Generic Tax Policy Process has – mostly - delivered policies which meet government objectives. But governments today need access to a wider, and faster, set of advice.

It is time to reform GTPP.

Recommendations

1. Retain GTPP, but encourage earlier, less formalised, consultation beyond a narrow group of tax professionals.
2. Establish a board of taxation, under the direction of the Minister of Finance and/or Minister of Revenue with a mandate to:
    a. Review draft legislation prior to its introduction to Parliament to ensure workability and technical accuracy,
    b. Carry out post-implementation reviews of tax policy, encompassing both operations and legislation,
    c. Recommend remedial changes to tax law,
    d. Assist in facilitating wider consultation on topical issues, and
    e. Carry out other enquiries as requested by the Government.
3. Appoint members to the board of taxation on a rotating basis, drawing on a range of skills and perspectives including business, Māori, academic, civil society and tax professionals.
4. Create a Taxation Select Committee to ensure more in-depth Parliamentary scrutiny of tax policy and operational matters.

[177] John Donne, Devotions Upon Emergent Occasions (1624)

A good tax system must be sustainable, with the ability to reform and evolve over time.

The Generic Tax Policy Process has fallen short of its potential

The Generic Tax Policy Process (GTPP) has served New Zealand well. It has three main objectives:

- To encourage early, explicit consideration of key policy elements and trade-offs,
- To provide an opportunity for substantial external input into the policy formation process, and
- To clarify the responsibilities and accountabilities of participants in the process.[178]

In substance, GTPP has tended to take the form of the Government proposing change through some form of consultation document, considering written submissions, and legislating its final decisions.

Implementation and review of policy has been a particular weakness: Parliament is not well-placed to oversee detailed, technical rules while post-implementation reviews have at best been a token rubber stamp, if they have in fact occurred at all.[179]

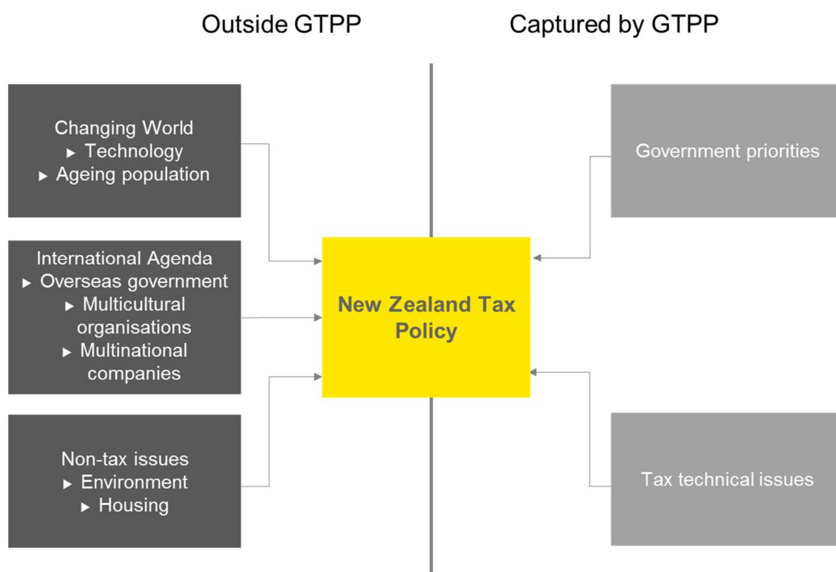
GTPP is no longer sustainable in its current form

The world of tax has seen more transformation in the past five years than in the past 50; the next five are likely to bring even more change.

Fatally, GTPP assumes it is possible for a small group of (mainly IRD) officials to gather sufficient, high quality external views in this changing world.

Small open economies, however, no longer have autonomy on tax policy issues – no country is an island. Our agenda is driven from overseas (as with the BEPS and digital tax issues), through non-tax priorities (environmental issues, housing) and forces outside the ambit of tax professionals (technology, population ageing).

Forces impacting on New Zealand tax policy



Even a well-run and well-resourced GTPP will be unable to respond to all of these forces. It needs institutional support.

Tax policy struggles to deliver efficient outcomes

Voters will always be poorly informed on tax policy.[180] Chances are, any given issue will be seen in isolation, with disconnected policy debates on the rise.[181] Institutional reforms which improve transparency and public understanding can mitigate, but not eliminate, this problem.

There are also inherent biases in policymaking:

- Retention of the status quo - any government policy creates a support group which will argue in favour of its retention. That policy will be built into pricing and industry eco-structures – so will be hard to eliminate if the government priorities

[178] Sir Ivor Richardson, Report on the Organisational Review of the Inland Revenue Department (1994)
[179] Emerging problems with GTPP were detected as early as the McLeod Review (2001) and reaffirmed by the Victoria University of Wellington Tax Working Group (2010).
[180] This will be so even for the Group, notwithstanding the innovative social media techniques adopted and the Group's open approach to communications beyond the tax professional audience.
[181] Discussion around sugar taxes is a case in point.

change. R&D tax incentives and film production incentives are two such examples. If New Zealand wishes to be an innovative, creative country with a screen production industry, these two items will be part of its toolkit.

- Official orthodoxy predominates – for a technical subject such as taxation, the ability to implement technical changes lies with the executive, which in turn depends on IRD officials.

Unequal access - concentrated, organised groups have a disproportionate advantage in seeking policies from which they benefit, as the costs will be spread across the entire population, which will be unlikely to oppose what may be a small or invisible impost.

Parliamentary scrutiny is weak

Parliament is not well placed to address these biases. It is unreasonable to expect the current Finance and Expenditure Select Committee to devote scarce Parliamentary time to correcting legislation, or to carrying out in-depth post-implementation reviews of policy.

The reality is that Parliament has neither the time nor the skill nor the desire to undertake any systematic or effective examination of whatever tax rules the government of the day places before it for its approval.

A stronger Parliamentary consideration of tax issues would include a meaningful and informed debate about taxation policy. Parliament needs to discuss the economic implications of proposals and alternative policy choices. It is hard to see that fixing technical errors in draft legislation is a good use of Select Committee time.

One option would be to create a separate Taxation Select Committee giving members more exposure to tax issues and with greater access to specialist expertise.

A strong focus on supply of taxation statistics to inform policy debate will assist

As outlined in this submission, tax policy requires a complex interaction of global competitiveness with policy drivers, applied to the actual facts of New Zealand incomes, wealth and tax payments.

As noted earlier, the natural behavioural desire of participants to seek their own agendas, there are challenges if the population does not have access to high quality tax statistics.

We observe for example that Australia has seen in recent months a strong debate about perceived inequality of income and tax "fairness" of payments but the top percentage or quintile bands of Australian taxpayers. The debate release by the Australian Taxation Office of statistics demonstrating the significant tax payments by the top income bands[182] has added significant light onto the debate, but the delay in that release has potentially distorted the debate in the intervening period.

For this reason we highlight the need, in today's knowledge economy, of timely, consistent and frequent releases of key data about relevant data relevant in the tax policy context.

We see that such data and statistics are important to retain public confidence and political confidence in the appropriateness of New Zealand tax policies.

We suggest therefore a substantial focus on tax statistical transparency and information, to drive the debate going forward.

A board of taxation could improve scrutiny

In 2000, Australia established a Board of Taxation, charged with contributing a business and broader community perspective to improving the design of taxation laws and their operation. A comparable board for New Zealand could:

Through its membership, broaden the range of skills and interests brought to bear on tax policy issues.

- Bring an enduring focus on tax reform to government.
- Review "exposure draft" or equivalent legislation to ensure it works on a technical level: that is, the legislation delivers government policy.
- Carry out post-implementation reviews of

[182] http://www.afr.com/news/ato-tax-statistics-top-10pc-pay-45pc-of-net-tax-top-1pc-pay-17pc-20180427-h0zcn1

tax policy, operations and legislation.

- Recommend remedial amendments to tax law within the framework of government policy.

Membership could appointed on a rotating basis, according to the needs of the government of the day, to include business, Māori, academic, civil society and tax professional skills.

The appointment criteria used for Crown entity and State Owned Entity boards could prove a useful model to follow.

Chapter 8

8. Summary of our recommendations and their potential benefits

Chapter 1: Framework for a good tax system

Recommendation	Revenue	Inclusive Growth	Equity	Living Standards Impact[183]
1. Endorse and use established criteria to assess whether the tax system is sustainable.	↔	↔	↔	
2. Draw on the Living Standards Framework as a pointer for future work, but not yet for policy recommendations – it remains insufficiently developed.	↔	↔	↔	
3. Changes should first be assessed against whether they will damage our existing strong position.	↔	↔	↔	

Chapter 2: The future of work

Recommendation	Revenue	Inclusive Growth	Equity	Living Standards Impact
1. Tax reforms should allow for flexibility in working arrangements.	↔	↗	↗	S H
2. One option would be to create a class of “dependent contractors”; those who have a contractor relationship, but are effectively under a high degree of control.	↔	↗	↗	S H
3. Simplify the tax obligations for dependent contractors, potentially by restricting deductions.	↗	↗	↗	S H
4. Develop smart withholding techniques to replicate income tax for dependent contractors (and potentially contractors in general).	↗	↗	↗	S H
5. Apply “dependent contractor” status in a standardised way across all employment laws.	↔	↗	↗	S H
6. Use technology, such as Blockchain, to strengthen integrity of tax administration for individuals.	↗	↗	↗	S H

1. [183] References are to the Four Capitals in the Living Standards Framework – Financial/Physical (F/P), Human (H), Natural (N) and Social (S).

Chapter 3: Taxes and productivity

Recommendation	Revenue	Inclusive Growth	Equity	Living Standards Impact
1. Consider reforms to the corporate tax system to enhance productivity.	↔	↗	↔	F/P H
2. To that end, further investigation of:				
a. Targeted measures which may have a more significant impact on business investment,	↘	↗	↔	F/P
b. Bespoke rules for SMEs based on the integration principle, and	↔	↗	↗	F/P
c. Whether design challenges associated with progressive corporate tax rates for SMEs can be overcome.	↔	↗	↗	F/P
3. Consider rebalancing taxes towards immobile factors such as land.	↔	↗	↗	F/P
4. Where possible, tax at the corporate level should be fully integrated with tax at the ownership level:	↔	↗	↗	F/P
a. For smaller businesses, seek to achieve full integration.	↔	↗	↗	F/P
b. For larger businesses, imputation remains the best approximation of integration.	↔	↔	↔	
c. Extend Māori authority regime to include wholly owned subsidiaries.	↔	↗	↗	S F/P
5. New Zealand should respond to tax challenges caused by digitalisation of the economy:				
a. Investigate nexus, profit allocation rules and place of consumption for digital businesses.	↔	↔	↔	
b. Monitor digital services tax developments, for example, current EU proposals.	↔	↔	↔	
6. Radical reform to New Zealand's corporate tax base or taxation of SMEs is currently not required.	↔	↔	↔	

Note these recommendations are finely balanced, as:

1. Economic literature provides sufficiently strong advice on a general direction of reform, but not on the size or enduring growth effect.
2. Studies are not based on New Zealand data so take little or no account of imputation.
3. Other policy priorities, such as coherence or ease of administration may outweigh the productivity benefits of corporate tax reform.
4. Both economic theory and country practice will develop in the next decade - other countries may overcome the practical and theoretical challenges of radical reform. In that case, New Zealand should consider becoming a fast follow of other productivity enhancing reforms.

Chapter 4: Opportunities for effective environmental taxation

Recommendation	Revenue	Inclusive Growth	Equity	Living Standards Impact
1. Tax should be part of the Government's toolkit for dealing with environmental issues.	↗	↔	↘	N S
2. The Group should agree good principles for environmental taxation including:				
a. An initial presumption against the introduction of selective taxes tempered by the understanding that the Government's international commitment to take transformative action on climate change is compelling.	↔	↔	↔	N
b. Environmental tax bases should be targeted to the pollutant or polluting behaviour.	↔	↔	↔↘	N S
c. The scope of an environmental tax should match the scope of the environmental damage.	↔	↗	↘	N S
d. The tax rate should be commensurate with the environmental damage.	↔	↗	↘	N S
e. The tax must be credible and its rate predictable	↔	↗	↘	N S
f. Distributional concerns should be addressed through other policy instruments.	↔	↔	↗	N S
3. There is a prima facie case for further investigation of:				
a. Including agriculture within the NZ ETS or any future carbon tax. We believe there is a case for bringing agriculture within the NZ ETS sooner rather than later.	↗	↗	↘	N S
b. Pricing roading taxes taking into account environmental factors as well as transport needs.	↗	↗	↘	N S
c. Broadening roading taxes from ad valorem to include an element of congestion charging.	↗	↗	↘	S N
d. A resource rent tax or royalty on the exploitation of natural resources not currently subject to royalties, such as water.	↗	↗	↗	N S
e. Considering how the Group's preferred principles for environmental taxation apply to water quality and usage.	↗	↗	↗	N S

Chapter 5: Capital taxation

Recommendation	Revenue	Inclusive Growth	Equity	Living Standards Impact
1. There is a case at the margin for tilting the balance of capital taxation from flows – such as interest and dividends – towards stocks – such as land and other stores of wealth.	↔	↔	↗	S
2. The impact of the tax system on income and wealth needs to be considered on a holistic basis:				
a. Reconsider the current TTE approach towards taxing private savings.	↘	↗	↗	F/P S
b. Move towards taxing real rather than nominal gains.	↘	↗	↔	F/P
c. Investigate the possibilities of wealth taxes and land taxes (noting their potential substitutability and overlap).	↗	↗	↗	F/P S
3. If the Government has concerns regarding residential investment property, consider reforms targeted to the specific problem.	↗	↗	↗	S F/P
4. If the Government has concerns regarding all forms of capital investment, consider a broad-based CGT.	↗	↗	↗	S
5. When designing a CGT:				
a. The best theoretical design would be wide-ranging, on a broad asset base, with an element of accrual taxation. Given the exclusion of the family home and the familiar difficulties with accrual taxation, we are into a "second best" world.	↗	↗	↗	S
b. Ideally, tax should be imposed on real rather than nominal gains.	↘	↗	↗	F/P
6. We accept that a realisation-based CGT is a much more likely outcome. Design of such a tax should be based on:				
f. Minimising the number of realisation events	↔	↔	↔	
g. Approximating real gains, for example, by way of taper relief	↘	↗	↗	
h. Ring-fencing capital losses	↗	↔	↔	
i. Taxing gains from a valuation day	↔	↔	↔	
j. Minimising exemptions and reliefs	↗	↔	↘	
7. We retain doubts regarding a separate CGT given the family home is to be excluded.				

Chapter 6: GST is New Zealand's most effective tax

Recommendation	Revenue	Inclusive Growth	Equity	Living Standards Impact
1. Maintain existing GST base as the case for selective zero rating or lower rating is weak.	↔	↗	↔	S
2. Address any distributional concerns through other parts of the tax system.	↔	↗	↗	S

Chapter 7: Tax reform process improvements required

Recommendation	Revenue	Inclusive Growth	Equity	Living Standards Impact
1. Retain GTPP, but encourage earlier, less formalised, consultation beyond a narrow group of tax professionals.	↔	↔	↔	S
2. Establish a board of taxation, under the direction of the Minister of Finance and/or Minister of Revenue with a mandate to:	↔	↔	↔	S
a. Review draft legislation prior to its introduction to Parliament to ensure workability and technical accuracy,	↔	↔	↔	S
b. Carry out post-implementation reviews of tax policy, encompassing both operations and legislation,	↔	↔	↔	S
c. Recommend remedial changes to tax law,	↔	↔	↔	S
d. Assist in facilitating wider consultation on topical issues, and	↔	↔	↔	S
e. Carry out other enquiries as requested by the Government.	↔	↔	↔	S
3. Appoint members to the board of taxation on a rotating basis, drawing on a range of skills and perspectives including business, Māori, academic, civil society and tax professionals.	↔	↔	↔	S
4. Create a Taxation Select Committee to ensure more in-depth Parliamentary scrutiny of tax policy and operational matters.	↔	↔	↔	S

Chapter 9

9. Glossary

ACE	Allowance for Corporate Equity
BBLR	Broad-base low-rate
BEPS	Base erosion and profit shifting
CBD	Central Business District
CBIT	Comprehensive Business Income Tax
CFT	Cash Flow Tax
CGT	Capital gains tax
EET	Exempt-Exempt-Taxed
EU	European Union
FBT	Fringe benefit tax
GDP	Gross domestic product
Group	Tax Working Group
GST	Goods and services tax
GTPP	Generic tax policy process
IFA	International Fiscal Association
IMF	International Monetary Fund
IP	Intellectual property assets
IRD	Inland Revenue
IRS	United States Internal Revenue Service
ITA 2007	Income Tax Act 2007
METR	Marginal Effective Tax Rate
MIT	Managed Investment Trust (Australia)
NCI	Normal Corporate Income (Singapore)
NZ ETS	New Zealand's Emission Trading Scheme
NZTA	New Zealand Transport Agency
OECD	Organisation for Economic Co-operation and Development
PAYE	Pay-as-you-earn
Paper	Background Paper of the Tax Working Group
Paris Agreement	Paris Climate Change Agreement
PIE	Portfolio investment entity
PPP	Public private partnership
PSGEs	Post-settlement governance entities

R&D	Research and development
RFRM	Risk free return method
RWT	Resident withholding tax
SGX	Singapore Exchange Limited
SME	Small and medium-sized enterprise
SOE	Small-Open Economy
S&P	Standards and Poor's
TTE	Taxed Taxed Exempt
UK	United Kingdom
US	United States
VAT	Value added tax

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