Tax Working Group Public Submissions Information Release

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30 April 2018

Future of Tax – The Tax Working Group

Dear Sir / Madam

Thank you for the opportunity to provide our thoughts and comments to the Tax Working Group (TWG). We support the TWG's review of New Zealand's current tax system and we recognise the importance of regularly reviewing the appropriateness of the current tax settings to ensure they still provide the right outcomes for New Zealand. Given the high rate of social, technological, and environmental change, it is important to challenge the tax system to ensure it still aligns with New Zealand's objectives and operates efficiently.

We also support the TWG's engagement with wider New Zealand in its review. This ensures diversity of thought as well as educating the public about New Zealand's tax system and the need to consider change. Increasing the conversation about the tax system is important as changes in the use of labour and technology will invariably require a more flexible and adaptable tax system than has perhaps been necessary in the past.

The 'Future of Tax: Submissions Background Paper' (page 16) recognises that the primary objective of a tax system is to provide revenue to fund public goods and services as well as redistribution. While the use of the tax system may also address other objectives, such as specific social and societal priorities, we emphasise the importance of not losing sight of the overwhelming primary purpose of the tax system to fund public services that are vital to all New Zealanders e.g. healthcare, infrastructure, and education.

The current New Zealand tax system raises revenue of c.32% of GDP. While we welcome positive change to the current tax settings, we caution that any change should be considered in a cohesive manner. New Zealand's tax system needs to continue to deliver day after day so that it provides the level of revenue required for the Government to continue to fund its objectives. Ideally, the tax system should be one that is easy to implement and simple to interact with. Therefore, it is preferable that any additional complexity arising from changes should be minimised to ensure the system continues to operate effectively and efficiently on a day-to-day basis.

In addition to the points raised above, we outline below our comments on other key issues raised in the Submissions Background Paper, as well as specific discussions on capital gains tax (CGT), goods and services tax (GST), and the role of the tax system in incentivising savings.

Qualities of a good tax system

The Submissions Background Paper recognises the more traditional and established frameworks used previously in the design of our tax system. This includes assessment on the following qualities: efficiency, equity and fairness, revenue integrity, fiscal adequacy, compliance and administration costs, and coherence.

In addition to these qualities, the Submissions Background Paper also outlines the TWG's use of The Treasury's Living Standards framework as an additional mechanism to assess the impact any recommendations could have on the wider well-being of New Zealanders.

We welcome the use of the Living Standards framework to assess the potential impact of changes. The Living Standards framework considers the potential impact in a more comprehensive manner than simply using traditional criteria. The use of the four capital stocks (financial and physical; human; social; natural capitals) will provide a broader picture of the potential impact and assist in highlighting the intergenerational impact of any changes immediately and in the future. We consider the overlay of intergenerational thinking to be an important perspective when considering fairness in the tax system.

While we welcome the use of the Living Standards Framework, we also support the continued use of the traditional criteria to assess changes. The use of both frameworks is helpful to provide multiple layers of thinking in which to assess proposed recommendations.

Fairness of the tax system

The fairness of New Zealand's tax system is a key area that the TWG is considering. In particular, the fairness of the tax system in the context of changing demographics (aging population and fiscal pressures) as identified in the Submissions Background Paper, as well as concerns about inequality.

The Submissions Background Paper notes that the New Zealand public is concerned about inequality and that the tax system (along with redistribution and spending) can play a role in combatting inequality (page 15). Equality is an important feature sought in a tax system as it ensures sustainability and ensures taxpayers remain engaged with and supportive of the system. It is therefore critical that this concern is addressed to ensure New Zealand's tax system will continue to have the support of the general public.

A key aspect of fairness is horizontal equity – where taxpayers in the same circumstances or earning the same amount of income should pay the same amount of tax. The current tax system enables situations where this is not the outcome e.g. New Zealand's current distinction between the way labour and capital is taxed as well as the way certain capital gains are taxed. A person's income from labour will generally all be subject to income tax while, under the current tax system, only some forms of income from capital are taxed (we discuss CGT further below).

Where horizontal equity is not apparent, there is a risk that the tax system will be perceived as unfair. For a tax system to operate effectively, perception is often as important as reality. New Zealand's tax system relies on self-assessment by taxpayers. A system that is perceived to be unfair could impact on the behaviour of the taxpayers, including their decision to be compliant or not.

In our view, there is a clear need to assess and address horizontal equity in New Zealand's tax system to ensure it continues to be one that encourages taxpayers to comply with their tax obligations, especially in the context of a self-assessment environment.

Capital gains tax

It is important to note that New Zealand currently taxes some income from capital already. Either in the form of the 'purpose and intention' test, which requires interpretation and is generally difficult for taxpayers to apply, or through specific taxing regimes, with the result being some capital gains (such as shares) are untaxed while other capital gains (such as bonds) are taxed (in some cases on an unrealised basis). The current tax settings therefore raise fairness issues.

This current ad hoc and complex approach to taxing capital income also contributes to a lack of compliance and erosion of the potential tax base. Taxpayers simply do not understand the rules and may not return tax on gains unless advice is sought. The coherence of the tax system is reduced as is horizontal and vertical equity. Furthermore, it also raises a real question as to whether New Zealand's current tax system is truly broad-base-low-rate (BBLR).

While there may be fairness arguments supporting the introduction of a more comprehensive CGT, we note that other factors also need to be considered. Based on overseas experience, it is sometimes argued that a CGT can be complex for the level of revenue it generates, particularly if many exclusions are included.

We understand the inclusion of owner-occupied housing in a CGT regime is excluded from the terms of reference of the TWG review. However, we note that 64% of households are owner-occupied.[1] This means a significant proportion of New Zealand housing will likely be outside the scope of any potential CGT raising questions as to coherence and efficiency of the resulting CGT.

In our view, the introduction of a CGT requires careful consideration to ensure a balance is struck so that the resulting tax will have the necessary features of a good tax system, including coherence, equity, and fairness and low administration and compliance costs. At a high level, if the overriding policy rationale is that all income, regardless of form (i.e. labour or capital), is to be taxed then a CGT with as few exemptions as possible seems appropriate. Finally, any CGT should have a goal of minimising complexity resulting in a tax that is simple, intuitive, and easily understood.

Specific design issues

We comment on the following design issues that may arise in the development of a CGT:

- *Certainty* – The current tax settings result in significant uncertainty as to when it could apply as it is heavily reliant on interpretation of the taxpayer's purpose and intent at the time the asset is acquired. In addition, there is a degree of non-compliance due to the lack of understanding of the current rules. Any CGT implemented should provide greater certainty as to when it applies. We note that the broader the tax (i.e. the more that is included in the tax net), generally the greater the certainty. GST is a good example of this.

- *Differential rates* – The taxation of income from capital at marginal tax rates would limit the opportunity to structure around the tax. This would effectively treat income from labour and income from capital in the same manner.

- *De minimis* – We recognise that the inclusion of a de minimis would help reduce compliance costs. It may be appropriate to include a de minimis to ensure the additional time and expense that is incurred by the taxpayer in complying is justified by the additional revenue that is generated.

[1] Statistics New Zealand, Dwelling and household trends: 1991 - 2015

- *Accruals vs realisation basis* – It is critical that any CGT is applied on a realisation basis. Significant cash-flow difficulties could arise if the CGT is applied on an accrual basis as taxpayers may not have the necessary cash to meet their tax liabilities. It may also be difficult to ascertain values of assets on an accruals basis.

- *Rollover relief* – Roll-over relief should be made available as it is critical to ensure the tax does not hinder economic growth. However, the scope of the relief will need to be considered in more detail. Our initial thought is that it should be made available for productive assets.

- *Capital losses and deductions* – It would seem unfair to tax capital gains while disallowing a deduction for capital losses and expenditure incurred in deriving those capital gains. The ring-fencing of capital losses may discourage risk-taking. However, we note that difficulties may arise around the calculation of the cost base. For example, what are the deductible costs created in building a business? Should goodwill be used as a proxy for the capital gain? Further, the deduction of capital losses may erode the tax base if it can be applied to other forms of income.

- *Indexation* – Australia's capital gains tax incorporates an indexation method to allow individuals to adjust their capital gain in relation to an asset held for over a year for inflationary aspects. This is required to limit the taxation that is paid on inflation. Care should be taken to ensure the resulting mechanism is not overly complex.

- *Residents and non-residents* – Any CGT should be imposed on New Zealand residents as well as non-residents on any New Zealand based property. Appropriate double tax agreements will need to be in place to ensure foreign direct investment in New Zealand is not discouraged due to the risk of double taxation.

- *Collection* – New Zealand currently operates a 'self-assessment regime' but the system often relies on the tax being collected and paid by another person and not the taxpayer. Examples of this include PAYE and the PIE regime. We acknowledge that it is often a more efficient collection mechanism. However, this often results in additional compliance costs for the payer. The design of the payment of the CGT should also consider the need to capture any non-residents holding New Zealand based property.

Our comments on CGT is summarised as follow:

- The current CGT is not cohesive or well understood and difficult to apply.

- The lack of a more comprehensive CGT has caused considerable complexity in New Zealand including the introduction of arbitrary and ad hoc tax rules to try and limit taxpayers' exploitation of this large exemption in our otherwise broad tax base. It also does not align with a BBLR tax system.

- Combined with the impact of discriminatory effective tax rates that applies across different types of income, horizontal equity and intergenerational equity are threatened. We agree with the view that consistent treatment should improve both fairness and efficiency.

- As evidenced by the design issues outlined above, a considerable amount of planning will be required to achieve a more balanced and efficient tax system while avoiding additional complexity and maintaining effective revenue generation.

We also note that Submission Background Paper states the overall desire to maintain a tax system that generates tax revenues of c.32% of GDP. On this basis, it may be worthwhile to consider if other tax changes that may be revenue negative, but beneficial for New Zealand overall, are appropriate as a result of any additional revenue that may be generated by a more comprehensive CGT.

Goods and services tax

New Zealand's holistic approach to GST is broad base, relatively low rate, intuitive and largely unavoidable. These are generally considered features that form part of a good tax system and, for these reasons, the GST system efficiently raises over 30% of Government revenue (in excess of $20 billion annually) with fairly low compliance costs. It consistently captures any bursts of economic growth (e.g. increased spending if a major sporting or cultural event is hosted in New Zealand) and is 'neutral' as any goods and services that are consumed in New Zealand are generally subject to New Zealand GST.

New Zealand GST is a relatively straightforward system that is highly respected by tax designers around the world. Globally, similar value-added and consumption taxes tend to be riddled with exemptions and differential rates (often driven by political pressures), which commentators often criticise for lessening the efficiency of the tax. New Zealand's GST is regarded as 'best in class' globally because it is pure, broad, and simple.

There are currently three main exemptions from GST: financial services, long-term rental accommodation, and low value imported goods (*de minimis* updated at the time of the GST rate increase in 2010). These exemptions are well defined and reflect policy rationale that was sound at the time when the exemptions were initially introduced. Specifically, it was determined that it would be administratively too complex to value financial services, imposition of GST would unduly inflate rental income costs, and that it would be too costly to collect GST on all low value imports.

However, we acknowledge that it is important to revisit the design of our GST system to ensure that it continues to be world-class, especially in light of the rapid changes that New Zealand and the rest of the world is facing in a digital age. An example of this is the issue of imposing GST on the importation of low value goods into New Zealand.

We also acknowledge that New Zealand's comprehensive GST system is regressive as lower income households tend to spend a larger proportion of their income on consumption and therefore on GST.

GST exemptions

Where certain goods and services are excluded from GST, careful consideration should be given so that there is absolute clarity as to the desired outcomes and whether the exemption will sufficiently achieve those desired outcomes. There is also a need to adequately consider whether there is another way for the Government to achieve those desired outcomes without using the tax system.

Experience from other jurisdictions suggests that the use of GST exemptions is often poorly targeted for the following reasons:

- It is inherently difficult to target a particular consumer by virtue of GST being a regressive tax.
- There is a risk any price differential may be absorbed by retailers.

- If the consumption of a particular good is being encouraged, there is no guarantee that the price will be sufficiently elastic to produce the desired outcome.[2]

- Additional rule complexity (and new interpretation issues) adds to collection costs and business systems have to change resulting in greater business costs.

In our view, the current GST system results in minimum distortions (being broad base, low rate with minimum exemptions). If more exemptions are introduced, it is likely that there will be additional complexity and an increase in compliance costs. The additional compliance costs to sellers may be passed onto the ultimate consumers therefore increasing the costs of those goods and services.

We note that, if 'exemptions' are to be pursued, we recommend the TWG considers whether GST zero-rating is a more appropriate way to exclude products from the GST net. This could lessen the costs for sellers (e.g. from the inability to recover input GST on their expenses) and prevent the cost from being passed onto the consumers.

From a revenue perspective, the introduction of further GST exemptions will likely lead to a short-fall in revenue, therefore consideration will need to be given as to how that lost revenue will be recuperated. This would likely either be an increase in the rate of GST or the introduction of other taxes. The Treasury has previously concluded that economic growth can be increased by shifting the balance of taxation away from income taxes and toward a mixture of consumption taxes and taxes on immovable property.[3] There is therefore a question as to whether the reduction of the GST base is beneficial from an economic growth perspective.

While further exemptions may help alleviate the regressive nature of GST, we question whether there is a better way to achieve this (e.g. the transfer system). The Submissions Background Paper (Figure 10, page 31) illustrates that the transfer system in New Zealand is reasonably effective, with the bottom five income deciles collectively paying less than 20% of all income tax while receiving 70% of all Government transfers. GST is not the only option available to reduce household costs and incentivise consumer behaviour.

Healthy foods

There has been significant discussion in the New Zealand media about a GST exemption for healthy food (fruit and vegetables) from GST to improve affordability and incentivise healthy eating. We therefore comment on the potential exemption of GST for ‘healthy foods’.[4]

There is ample of evidence that healthy food is often comparatively more expensive than other less healthy options and that low income households consume less healthy food. However, we question whether the introduction of a GST exemption on 'healthy food' options would benefit those at which the exemption is aimed. It is difficult to target a GST-exemption on certain types of food to specific buyers. Therefore, it is likely that the exemption would benefit all buyers including those who already have the economic means to purchase healthy foods. As such, it is an expensive way for the Government to assist those families who are on lower incomes as the assistance will effectively be available to all consumers.

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[2] Child Poverty Action Group (2010). *Will Removing GST on fresh fruit and vegetables achieve its stated aim?*
[3] EUCOTAX Series on European Taxation, The Future of Indirect Taxation, Recent Trends in VAT and GST Systems Around the World, Thomas Ecker, Michael Lang & Ine Lejeune, 2012
[4] We note that there are issues as to whether 'food' would include fruit/vegetable juices and whether any percentage thresholds would exist to make the determination e.g. pasta/vegetable or stir-fry/vegetable pre-mixed packages or combinations.

Given this proposal intends to target certain demographics, we question whether the transfer system is a more appropriate way to deliver the desired outcome and provide some compensation to households currently suffering a disproportional burden under the current GST system.

Incentivising savings behaviour

New Zealand's tax system is relatively neutral in the sense that it does not overtly seek to change behaviour (with the obvious and noted exception of alcohol and cigarette duties). However, tax incentives may be appropriate to achieve greater horizontal equity and promote behaviour that serves New Zealand's social and economic goals. Incentives may take the form of any concession, rebate, credit, subsidy, or contribution the Government makes towards changing behaviour to achieve a social or economic goal.

We acknowledge the design of any tax incentive must be carefully considered to ensure it is well targeted, adequately funded, and maintains the integrity of the tax system. New Zealand's past use of tax incentives has largely been poorly targeted, expensive, and inefficient.

We outline below a framework to consider when evaluating the use of incentives, with a particular focus on savings incentives:

- *The need for incentives* – The use of incentives is an option available to the Government to correct market failures. Arguments that would support a tax incentive in the context of savings include the need to increase national savings, horizontal equity, and economic growth while decreasing dependency on state provided retirement income. Data included in the Submissions Background Document (page 40, figure 21) highlights the disparity between marginal effective tax rates on different types of savings. Bank accounts are taxed at a marginal effective tax rate of 55.7% while property investments are taxed at a marginal effective tax rate of 29.4%. The non-deliberate taxation incentives are arguably distorting the efficient allocation of what savings New Zealanders do have.[5]

- *Design* – A tax incentive should be structured to correct market failures, as opposed to creating distortions. This is particularly relevant in the context of savings given the potential distortionary effect on investment choices as outlined above.

- *Likely impact* – Any tax incentive must be carefully modelled and the flow-on economic consequences thoroughly considered. In some instances, the incentive may only neutralise any distortions instead of incentivising a certain behaviour. In the context of savings, an incentive may level the playing field between different investments but it may not increase savings if the individuals do not have the capacity to save (e.g. those on lower incomes may not have the ability to benefit from the incentive as they need to consume a larger portion of their income).

- *Risk of irrational behaviour* – We acknowledge that the impact of tax incentives can be difficult to predict. The Submissions Background Paper illustrates bank accounts are among the most punitively taxed investment in New Zealand, with the effective tax rate of PIE savings being 8.5% lower. However, taxpayers are nevertheless still placing their savings into a bank account despite the significantly higher effective tax rate.

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[5] Craig Stobo, Consensus of the Taxation of Investment Income, 2004

- *Objectivity* – When the rationale for granting tax incentives is based more on discretionary and subjective qualification requirements, instead of automatic and objective requirements, they can originate rent-seeking behaviour and manipulation of the granting process.

- *Funding* – For the use of incentives to be fiscally neutral, the tax base will need to be expanded or rate heightened in another area. Specifically, the use of taxation incentives may result in inefficiency, fiscal costs, and distributional effects (greater benefit to high income earners). Looking forward, an incentive may become more costly as behaviour is induced. For example, the cost of a savings incentive may increase as society increases its saving level.

We are of the view that incentives may be used to achieve greater horizontal equity. In the case of savings, incentives may result in an alignment of the marginal effective tax rates on various investments. For example, the low effective tax rate on rental property investment is likely disincentivising New Zealanders to invest in productive assets. This limits the capital available to grow our economy. Given New Zealand's aging population, we consider it important to encourage saving for retirement.

Concluding comments

We support the current review of New Zealand's tax system by the TWG and we support the ongoing review of the tax settings on a regular basis. The tax system should continuously evolve to keep pace with external changes to the environment in which it operates.

We emphasise the importance of remaining open-minded and open to change during these reviews in order to challenge the current tax settings and the thinking behind them. As noted in our submission above, we believe this is being done as part of the current review by the TWG as it considers the use of new taxes, such as incentives, and seeks to consider the overall equity of the tax system. The current review is also making a conscious effort in opening up the discussion to all New Zealanders therefore resulting in greater diversity in how we may challenge New Zealand's tax settings.

Finally, we consider that the tax system is not the only way to address some of the concerns outlined in the Submissions Background Paper. Consideration should also be given to other methods of facilitating change to maintain the integrity and operational efficiency of our tax system.

General

We appreciate the opportunity for PwC to contribute our views and comments to the TWG on the future of New Zealand's tax system.

Please feel free to contact us should you wish to discuss our comments further.

Yours faithfully
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