Tax Working Group
Te Awheawhe Tāke

Tax Working Group Information Release

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Coversheet: **Responding to Ministers on wealth, capital income and effective tax rates in the top decile**

Background Paper for Session 23 of the Tax Working Group
22-23 November 2018

Purpose of discussion

This paper provides information and a proposed response regarding the following request from the Ministers of Finance and Revenue in their letter of 20 September 2018:

"The Government recognises the limitation of current data on wealth distribution and capital income, especially within the top decile. We would like the Group to consider whether there are better approaches to understanding the wealth, capital income, and effective tax rates of individuals particularly those in the top decile."

Key points for discussion

- Whether the group is comfortable with a response in the Final Report that notes:
  - the Group has reviewed information from a range of sources to build up an understanding of capital income, wealth and effective tax rates;
  - while all data sources have their own limitations, overall it has built up a picture that net wealth (excluding the family home) and capital income are reasonably concentrated (albeit with a strong age pattern to wealth) and there have been significant untaxed capital gains over recent years that will have accrued to high wealth individuals; and
  - there is scope for improvement in data and modelling; some progress is being made by Stats NZ and the Treasury.

Recommended actions

We recommend that you:

a **note** that the Ministers of Finance and Revenue requested the Group *"consider whether there are better approaches to understanding the wealth, capital income, and effective tax rates of individuals particularly those in the top decile."*

b **agree** that the points in paragraphs 20-23 should be incorporated into the Final Report (in an annex) as a response to the Ministers' request.

Responding to Ministers on wealth, capital income and effective tax rates in the top decile

Background Paper for Session 23
of the Tax Working Group

November 2018

Prepared by the Inland Revenue Department and the New Zealand Treasury

TABLE OF CONTENTS

1. Introduction

1. The Ministers of Finance and Revenue wrote to the Tax Working Group on 20 September. The Ministers requested the following:

   "The Government recognises the limitation of current data on wealth distribution and capital income, especially within the top decile. We would like the Group to consider whether there are better approaches to understanding the wealth, capital income, and effective tax rates of individuals particularly those in the top decile."

2. This note provides a response to this request. It draws on information provided by Stats NZ.

2. Background

Household survey data

3. Household surveys are the most common source of comprehensive data on household wealth and income. In New Zealand, the Household Economic Survey (HES) provides distributional information on income, expenditure and wealth.

4. Regarding the distribution of household wealth, the secretariat used the 2014/15 HES household net worth statistics. Stats NZ will be publishing the 2017/18 household net worth statistics on 14 December 2018.

5. A known limitation of household survey data is that it can poorly represent the upper end of the income and wealth distribution. This is partly because a small number of households account for a disproportionate share of total income and wealth and the likelihood of including them in surveys is low.

6. A possible solution is to oversample high income or wealth households because of the unavailability of auxiliary information to identify them. In New Zealand, the high use of trusts poses additional measurement challenges for household surveys.[1]

7. In some countries, high income oversampling is used in an attempt to achieve better quality wealth data. Results from these surveys suggest that the oversampling strategy has not been very effective, and show low response rates among high-wealth groups. For example, the US Survey of Consumer Finances experiences response rates of about 10 percent for the wealthiest households. There are also problems of incomplete response. Financial asset questions tend to have higher non-response and lower data quality than real assets. This compares with an overall response rate of around 75 percent for HES.

8. Stats NZ has investigated oversampling high wealth individuals in its net worth surveys. Following this investigation, it was decided not to oversample to ensure a balance between cost and quality. Although it has been demonstrated that an oversample of high income households within the normal sample size would increase the quality of estimates at the top end of the wealth distribution, this would be at the

[1] HES does include data on the assets and liabilities of trusts of settlors or quasi settlors (a person in the household who reported being both a trustee and beneficiary of the trust). This approach is used because those who were only a beneficiary, or only a trustee, were less likely to know about the contents of the trust. Stats NZ report that some respondents were unsure of their relationship to the trust, which may have led to under-reporting of trust wealth.

expense of the quality of estimates for the rest of the population (since, for a given sample size, it implies fewer observations over the rest of the distribution). Stats NZ reports that data users have been unwilling to accept any reduction in the quality of estimates in the rest of the population for higher quality wealth estimates at the top end.

Alternative data sources

Administrative data

9. IRD publishes data on the distribution of individual taxable income (ensuring that taxpayer data is confidential). This enables an understanding of taxable income shares at the very top of the distribution (eg, top 1% or top 0.5%).

10. However, administrative data has two main limitations. First, by only including taxable income, it excludes non-taxed capital income that would be needed to estimate effective tax rates. Second, it does not collect wealth data. These are limitations that reflect current features of the tax system (eg, absence of taxing capital gains or wealth taxes). Potential future changes to the tax system could be associated with changes to the data available (eg, if more capital gains become taxable income).

11. Administrative tax data on investment income might perhaps be used to construct series on the distribution of wealth. This approach would entail estimating wealth by capitalising the incomes reported by individual taxpayers. It would involve the application of a capitalization factor to each asset class (dividends, interest, rents, profits etc) in such a way as to map the total flow of taxable income to total wealth recorded in macroeconomic household balance sheets. Whether or not this is feasible would be a significant research project best undertaken by an academic expert.

12. The tax capitalisation method may be problematic as not all assets generate taxable investment income for the individual. Therefore, while tax records provide information on the top tail of the wealth distribution, their usefulness and reliability remains limited.

Synthetic estimates

13. Synthetic estimates which draw on two or more data sources may be used to get a more accurate estimation of the distribution of income or wealth. For example, augmenting household survey data with income tax data for top incomes has proven to be effective in improving income inequality statistics in the United Kingdom.[2]

14. In New Zealand, there could be potential for merging survey and administrative data within the Integrated Data Infrastructure (IDI). This could entail confronting and/or replacing survey data, leading to an overall improvement in the quality, and granularity, of income and wealth data.

15. The Treasury has recently upgraded its modelling of the distribution of income, taxes and transfers. While based on HES, administrative data on taxable incomes has been used to improve the accuracy of the income distribution. This should lead to more

[2] Burkhauser, Richard V. and Hérault, Nicolas and Jenkins, Stephen P. and Wilkins, Roger (2018) *Top incomes and inequality in the UK: reconciling estimates from household survey and tax return data.* Oxford Economic Papers, 70 (2). pp. 301-326.

accurate distributional analysis. However, it is still limited by a lack of data on capital gains.

Information on high wealth individuals

16. Lists of large wealth holders such as the NBR rich list provide another source of information on the share of wealth owned by the wealthiest individuals.

17. The construction of the list draws on a wide range of public information, coming from a variety of sources. The estimates typically relate to identifiable wealth, such as land, property, art or significant shares in publicly quoted companies. However, the sources are often partial and therefore may not be accurate.

18. While rich lists may provide insight into the upper tail of the wealth distribution, it is not easy to assess their accuracy or representativeness.

3. TWG Response to Ministers

19. The following points form a suggested response to the Ministers' question. It is proposed that paragraphs 20-23 are incorporated into the Final Report (in an annex).

20. In responding to the Ministers' question, the Group could note that it has reviewed information from a range of sources to build up an understanding of capital income, wealth and effective tax rates. This has included:

    - reviewing analysis of the household wealth distribution using the Household Economic Survey;
    - reviewing past analysis undertaken in Inland Revenue on the wealth accumulation of high wealth individuals (with appropriate redactions to preserve taxpayer confidentiality). This paper has been released on the TWG website;
    - reviewing analysis of average effective tax rates of enterprises using tax administration data (IR10). While the data is on an enterprise level, many of the entities would be owned by high wealth individuals.

21. While all data sources have their own limitations, overall it has built up a picture that net wealth (excluding the family home) and capital income are reasonably concentrated (albeit with a strong age pattern to wealth). There have been significant untaxed capital gains over recent years that will have accrued to high wealth individuals.

22. There is scope for improvement in data and modelling. A key area of potential improvement is through the combined use of administrative and survey data. Work is progressing in this area. Stats NZ is increasing the sample size of HES and using administrative data to improve accuracy from HES 2018/19 onwards. The Treasury's model (TAWA) for producing household income distributional analysis was recently improved with combined survey and administrative data.

23. However, there remain limitations with data sources, especially with regard to capital income and wealth in the top decile. In particular, the lack of data on individual capital gains and likely under-coverage of high wealth households. Potential future changes to the tax system could be associated with changes to the data available (eg, if more capital gains become taxable income).