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Purpose, principles, and possibilities: The Tax Working Group

Introduction

Good afternoon. Thank you for the opportunity to talk with you today about aspects of the work of the Tax Working Group set up by the new Government just before Christmas.

I want to talk about five aspects of the Group. Hopefully, I will cover the first four briefly: the background to its formation, its terms of reference, its membership, and its proposed process.

Finally, I will move on to a somewhat longer discussion of the soon to be released Submissions Background Paper. I want to emphasise in particular the framework of purposes and principles which the Group has been developing at its first three full meetings.

Background

The reasons why the Labour Party went into the last election with a policy of a substantial review by a working group of the tax system are not, on the face of things, clear. Labour fought the 2014 election on a policy of introducing a comprehensive capital gains tax regime of 15% on realised assets, excluding the family home.

After the 2014 election some, including new leader Andrew Little, in part blamed the CGT commitment for the calamitous nature of Labour's defeat. Others remained of the view that the commitment was crucial to a better tax system and that there were other reasons which better explained the magnitude of the disaster.

It seems likely that the proposal to undertake a more general review of the system was a compromise between these opposing views.

Nevertheless, and inevitably, the vagueness of this policy left plenty of room for mischief-making by other parties and this led to some clarifications concerning limitations on the scope of the review.

The Terms of Reference

This brings me to the Terms of Reference for the review. In essence they are quite simple. The terms state that the Working Group has been established "in order to examine further improvements in the structure, fairness and balance of the system". Anyone who thinks that the terms were drafted by me can be immediately assured to the contrary by this statement: there is no Oxford comma after fairness.

The Terms go on to reaffirm the soundness of the established New Zealand guiding principle that tax should operate neutrally and as much in the background as possible.

As always when discussing the objectives and purposes of the tax system there is a tension between this stress upon simplicity and neutrality and other criteria. In the case of the Working Group's Terms of Reference these include such matters as fairness, promoting the long-term sustainability and productivity of the economy, supporting a sustainable revenue base to fund operating expenditure around current levels, treating all income and assets in a fair balanced and efficient manner (having special regard to housing affordability), and a progressive tax and transfer system.

We are also tasked with considering in particular the economic environment over the next five to ten years and the drivers of changes to that environment; whether taxing capital gains or land or other housing tax measures would improve the system; the possibility of a progressive company tax system; and what role tax has in delivering positive environmental and ecological outcomes.

The exclusions from the scope include consideration of inheritance taxes, any increases in the rates of income tax or GST, a capital gains tax or any other changes to taxation that would apply to the family home or the land under it, and the adequacy of the personal tax system and its interaction with the transfer system.

Also excluded are what are called "more technical matters already under review as part of the Tax Policy Work Programme", including tax reform under the Base Erosion and Profit Sharing agenda and policy changes as part of IRD's Business Transformation Programme.

In my view these exclusions and limitations do not unduly restrict the ability of the Tax Working Group to undertake a comprehensive review of the tax system. Some simply avoid repetition of work underway, while not precluding a broader consideration of the issues. Others simply reflect political realities. Even were the voice of God to emerge from the clouds telling us to have a CGT on the family home I am certain any New Zealand government would manage not to hear it!

Moreover, I am of the clear view that where there is ambiguity in some of the language the Group may legitimately take a fair, large and liberal interpretation of it. Finally, there are obviously some tensions between parts of the terms of reference. That seems to me an inevitability and could be described as simply part of the human condition.

Membership

The membership of the Group is both larger and more diverse than its predecessors. That is deliberate. That is not to say that tax practitioners are not well represented. Apart from the redoubtable Robin Oliver there is Geoff Nightingale (PwC), Joanne Hodge (ex-Bell Gully) and Michelle Redington (head of group tax and insurance at Air NZ). Also experts in various aspects of tax law and practice are Professor Craig Elliffe (University of Auckland) and Nick Malarao (Meredith Connell).

Hinerangi Raumati-Tu'ua is a chartered accountant and has held both governance and senior executive positions in Maori entities including currently as chair of Paraninihi ki Waitotara. Associate Professor Marjan van den Belt is an ecological economist and was, until recently, Assistant Vice Chancellor (Sustainability) at Victoria University. Finally, there is Bill Rosenberg, economist at the CTU, and Kirk Hope, chief executive of Business New Zealand.

Well, not quite finally of course. I am the chair of the Group, which might be taken to indicate the peculiar taste I have developed in so-called retirement for poisoned chalices. Our independent adviser is Andrea Black. Andrea holds degrees in economics, commerce, and taxation studies and has worked in senior positions for both Treasury and Inland Revenue.

The diversity of the Group means that we are far from being of one mind, culture, or philosophy. It might have been more efficient to have had just two economists and so got five opinions.

But I am very confident the diversity we have will add to the value of what we produce. This also means that we do not start from a position of a collective prejudgment of any of our conclusions, particularly on the more politically sensitive issues.

Process and time lines

The process the Group is following is reasonably conventional but we are looking for some variations to try to widen the basis for consultation. We have met three times so far and agreed the main processes for consultation as well as some key issues around the framing of our work.

A background paper on the main characteristics of the current tax system and future challenges and possibilities is close to completion and will be released on 14 March.

We called for submissions yesterday on the basis that groups like yourselves and others will not need the background document in order to start preparing their submissions. People not so familiar with the current system may still appreciate the extra time to think about what they want to say.

Submissions will be due in by the end of April. Apart from seeking (and receiving) views from the usual list of suspects – including your good selves with your various hats on – we will be trying to reach out to those less frequently involved in tax discussions. This will include environmental and community NGOs, property investors' associations, and small business representatives amongst others.

There will be specific engagement strategies for Maori and for youth. Somewhat unusually we will be seeking direct input from government agencies other than Treasury and Inland Revenue in order to bring a broader set of governmental perspectives and opinions to the table.

What we are asking groups, organisations and individuals to do is tell us their views on the future of tax. We will continue to update and provide further digital materials to aid in the discussion using a variety of means. Submissions will normally be released publically once tabled at a Working Group meeting, subject to any redactions required, in particular for privacy reasons. We want this to be an open process.

There will be multiple rounds of public communication during the submission period providing fresh material. This will test some of our media commentators who have a strong tendency to confuse discussion with decisions having already been made. This may make for good headlines and trenchant political reactions but it does not assist in good policy making.

We are tasked with presenting an interim report to the Ministers of Finance and Revenue in September. This is a very tight timetable. We anticipate there will be further public, political, and professional feedback on that interim report which will feed into the final report due by the end of February 2019.

The Future of Tax: Submissions Background Paper

As I said earlier, the first phase of the group's activity, is now nearing completion. It has centred on the production of the background paper to help inform submissions from a wide variety of groups and individuals, particularly those less familiar with our current tax system.

The paper is structured around six topics: the future environment within which the tax system will need to continue to provide adequate revenue to fund government programmes; the purposes and principles of a good tax system; the key features of the current New Zealand tax system; the key results of the current system; thinking outside the current system; and specific policy challenges which the Terms of Reference require the Group to address.

The Future Environment

As the great playwright Ionescu said, "You can only predict things after they've happened". When we do try to predict before the outcome there is often a tendency to fall into one of two errors: linear extension forward from the recent past, or an assumption that all will change and in an unpredictable fashion. The latter – usually summed up in the single word disruption – has been highly profitable for consultancy firms in recent times.

This enables us to make one confident prediction based on linear projection: consultancy firms will continue to make lots of money from incorrectly predicting the future. We can, however, point to some trends which are likely to have implications for the tax system.

1. *Demographic change*

The most obvious in many countries, including New Zealand, is changing demography. The most important part of this, in terms of its impact on tax, is the ageing of the population. The process is now well under way for the Pakeha population. It will progressively affect the other major ethnic groups as it is the result of a combination of falling birth rates and increasing life expectancy.

The consequences are likely to be lower rates of labour participation (and thus revenue from labour incomes) and increased expenditure on New Zealand Superannuation and health care. It seems unlikely that, beyond the ten-year horizon set for the Tax Working Group, operating expenditure will be kept as low as around 30% of GDP. The Treasury prediction for 2045 is just under 40%.

The other aspect of demographic change – the growth of so-called superdiversity – has less resonance for the tax system, whatever other political or policy challenges it presents.

The main point is that taxes on capital income may, *of necessity,* bulk larger in the future in total tax revenue. This will be particularly so if the general trend continues for the returns to capital to grow faster than the returns to labour.

Embedded within all of this are intergenerational equity issues which would require substantial retrospective – and thus impossible – action to address properly.

The real lesson is that we need a tax system which is able to flex easily in response to altered circumstances, some of which are beyond our capacity to predict, let alone control.

2. The nature of work

Changes in the nature of work – already evident – are likely to continue. The biggest of these, of course, are the elimination of existing jobs by new technologies. Economic Cassandras have been busy for a good 200 years predicting mass unemployment due to technologically driven change. They are like people who look at a doughnut and see only the hole.

So far general employment collapse from technological change has not happened to any great extent. Rather, new job creation has more than kept pace with job losses. In terms of participation in paid employment we are probably at or near long-term historic highs rather than teetering on the edge of disaster. Greed and the consequent recurrent financial collapses will arguably continue to have a greater negative effect on employment.

But the impacts of technological change can be serious at the regional or sub-regional level of course, whether in the United States or New Zealand. Crudely, however, that points to the need for sufficient revenue to pay for better adjustment policies rather than propping up dying industries or raising apocalyptic doubts about the revenue system or, indeed, the economy itself.

The one aspect of the changing nature of work which may well impact on revenue is the growing "gig economy". This is characterised by variable and uncertain hours of employment and the prevalence of supposedly independent contractors.

This all presents challenges for tax assessment and, even more, tax collection. A system which has come to rely heavily on voluntary compliance may find that was able to survive for a brief golden age rather than reflecting a paradigm shift. Let us hope not and that other solutions, assisted by the Business Transformation agenda will enable us to avoid coming to that conclusion.

3. Technological change

Apart from any direct impacts of technological change on employment its other most significant impact is via the way the internet has changed so much of our personal and public lives. Not just goods but now services are available at the touch of a screen. A new "sharing economy" has emerged where (for a price or by other means) assets such as houses and cars are shared.

Many of these developments provide further potential threats to the tax base, both directly and through changing attitudes to tax compliance.

On the positive side, technology lies at the heart of the IRD's Business Transformation agenda, opening up new possibilities for (and perhaps threats from) government administration.

4. The growth of the Maori economy

The growth of the Maori economy (not to be confused with Maori in the economy) is one of the most positive features of New Zealand over the last generation. It offers hope for all New Zealanders, not Maori alone.

The Maori economy asset base has been growing strongly and last year was estimated to be about six per cent of the national total. It tends to be concentrated in the primary sector, producing 30% of our lamb production, 30% of sheep and beef, and 10% of milk.

This concentration is beginning to change as Maori entities take what opportunities are available for diversification, limited to some degree by the impossibility of alienating the great majority of the current landholdings. That, however, strengthens the emphasis on intergenerational sustainability, and tikanga Maori.

Given the well-known disparities in Maori social and economic indicators compared with the rest of the population the encouragement of its further development and strengthening should be a matter of national priority.

In that respect the Working Group is interested in submissions and reflections from Maori in particular as to the effectiveness of the current Maori authority regime and how tikanga Maori could help create a more future-focussed tax regime.

We will also be looking for comment on specific issues we need to be aware of when considering options such as a more general capital gains tax or a land tax and, indeed, any other areas of the tax system from the point of view of te ao Maori.

5. *International tax trends*

Some would also argue that trends in tax rates and types of tax offshore may also necessitate similar changes in New Zealand. Most commonly cited is the downward trend in company tax rates which means that our rate is now slightly above the OECD average.

I would caution about self-interest leading to less than deep analysis here. New Zealand – with Australia – are the only two countries with full imputation systems for a start. Interestingly, some European countries went down the imputation track as early as the late 1970s but the European Court of Justice ruled in the 1990s that a domestic only tax credit system breached two of the four freedoms guaranteed by the Treaty of Rome.

Then there is the fact that the empirical evidence for a connection between company tax rates and economic performance remains very weak. That is true whether we measure across countries or look at ourselves over time. The kind of investment we need is likely to be based on far wider considerations than just minor differences in the headline company tax rate. Many of those considerations derive from effective government spending.

And, since those who argue most vehemently for company rate cuts tend to be the same people who argue the top personal income tax rate must be aligned with the company rate, we simply invite ourselves to lead a race to the bottom in terms of revenue. New Zealand already has to admit to having the fourth lowest level in the reduction in the Gini coefficient of inequality in the OECD through its tax and transfer system.

We need to be aware of what is happening elsewhere; but we also need to design and protect a system which suits our own needs and the agreed purposes that we have.

6. *Ecological and environmental challenges*

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.

We face many other environmental challenges such as water pollution, possible over-allocation of water, plastic pollution of the oceans, and congestion, in Auckland especially. The dismal list goes on and tends to grow rather than shrink. At the same time, we have calls to use the tax system as a partial solution to such problems as the incidence of obesity.

All this means that the possible use of the system to change people's behaviour in ways which increase the wellbeing of all of us is very much on the agenda at the present time. I have no doubt there will be a significant number of submissions in that respect.

Purposes and principles of a good tax system

The mention of the concept of wellbeing brings me neatly to the question of the possible purposes and principles of the tax system.

No-one has summed the fundamental core purpose better than the American jurist Oliver Wendell Holmes in 1927: "Taxes are what we pay for a civilized society". That assertion may be considered to be borne out by the fact that taxes are normally higher in rich societies than poor ones.

This association arises from the tendency in rich, democratic nations for the definition of a civilised society to expand with rising incomes. Thus, for example, there is a close relationship between expenditure on health care as a proportion of national income and per capita national income.

While taxation largely began as a way of funding national defence (or, more precisely in many cases, royal aggression) defence now usually represents in the rich democracies less than about five per cent of total government expenditure. In this instance the public sector has crowded out the public sector!

Taxation now collects between about a quarter and a half of national income in the rich world. The largest areas of spending are nearly always health, education, pensions, and other forms of income transfers, not always in that order.

Given the large amounts of money involved it is important to try to have frames of reference within which to judge the tax system according to broadly acceptable purposes and principles. The traditional criteria are expressed in terms of efficiency, equity and fairness, revenue integrity, fiscal adequacy, compliance and administration costs, and coherence. Obviously, I do not need to spell these out in detail for this audience but they will be more fully described in the background document.

Sufficient at this point to note that none of these criteria can be said to be entirely objective. They have served well for relatively narrow analysis but do not provide a sufficiently broad framework to encompass the range of views the public may have about the purposes and principles of the tax system.

The Tax Working Group will continue to use the traditional framework, especially with respect to the more technical issues.

In terms of values we will also place emphasis on the Living Standards Framework developed over some years by the Treasury.

I want to acknowledge in particular the work of Girol Karacaoglu in the development of the Framework. In Girol's own words, the purpose of public policy is to "increase collective wellbeing on a sustainable basis". Taxation is a matter of public policy and so needs to be consistent with that purpose.

The Living Standards Framework identifies four capital stocks that are crucial to intergenerational wellbeing. They are financial and physical capital; human capital; social capital; and natural capital. In the Treasury description of the Framework the four capitals are visualised as four interlocking strands.

The crucial point is that the Framework encourages public policy development to consider the complementarities of various options as well as their substitutability, interactions, and trade-offs. Most important it moves the discussion beyond a narrow concentration on financial capital. It also moves away from an implicit assumption that tax is a "burden".

The Living Standards Framework will therefore assist in making values judgments about particular proposals in relation to taxes. The traditional framework will stand alongside to ensure appropriate consideration is given to how well those proposals may work in practice. Other values tests may also be used - for example, the internationally agreed Sustainable Development Goals.

There are any number of what might be called "knobbly bits" embedded in any such set of criteria. The most obvious is fairness – specifically mentioned in our terms of reference. We can all parrot that there are two axes of fairness in taxation: vertical and horizontal.

I suspect that somewhere, deep in academia, three or even four-dimensional models of fairness are being developed. Concepts of fairness have changed over time, so the fourth dimension is already there.

We normally begin from two simple starting points. First, those who earn more should pay more (vertical equity). Second, those in the same circumstances should pay the same amount (horizontal equity).

From there onwards all is sound and fury hopefully in our case signifying more than nothing. I am sure the Group will spend some time on this. It is clear to me that one of the most important matters to discuss lies along that horizontal axis. Having decided what everybody should pay how do we make sure they pay it? And how do we do that in the gig cum internet economy? And if, effectively, we cannot under current arrangements what has to give?

What we do know is that, under our current system, those who commit benefit fraud are generally treated more harshly than tax evaders, both in terms of prison sentences and in terms of the write off of debts. This again reflects embedded cultural views about the relative morality of the two kinds of actions.

Then there is the question of behavioural responses to tax in general and specific taxes in particular. It is interesting to note that what has become our most unfair tax in terms of vertical equity – tobacco excise duty – is justified on behavioural grounds. And rightly so, says this ex-smoker/old leftie.

And if one holds the view – as many do – that our current economic system is far from sustainable, fair, or ethically sound then the notion that a particular tax is distortionary might be a good, not a bad, thing.

Having uttered what, for many in this audience, may be the ultimate heresy let me quickly pass on to the rest of the Submissions Background Paper.

The current New Zealand tax system

Chapter 4 describes the current New Zealand tax system. Following established conventions we congratulate ourselves on our broad-based low rate system. By that we mean that for those taxes we do have there are few exemptions or deductions.

We then go on to explain in some detail that we are not really broad-based or low rate (except for our GST, which we are tasked with examining whether it should be less broad-based).

By that I mean that the base of taxation has been narrowed since the great tax reforms of the 1980. Many taxes have been abolished, leaving us with a very narrow range of taxes by international standards. And it's highly unlikely the abolished taxes will be reinstated.

The most obvious area of narrowness is the very limited scope of our current capital gains tax regime. That reflects a long New Zealand tradition, the basis of which is hard to discern.

In addition, one of the many problems in comparing our system with those in the rest of the developed economies is that, other than for ACC, we do not level social security contributions separately from income tax. This makes our system look harsh, with income tax levied from the first dollar. However, if we combine income taxes and social security taxes then a very different picture emerges about other countries' taxes on very low incomes.

The results of our current system

What is reasonably apparent is that our tax and transfer system is right towards the lower end of being redistributive compared with the rest of the members of the OECD – only half as redistributive as that of Finland. On the other hand, our company income tax revenue as a percentage of GDP is right at the top end of the mainly rich club. But again, this ignores the significant other taxes levied on companies which are not levied in New Zealand.

Hopefully the data and charts in the background paper will help improve understanding a little. But the truth is that international comparisons are profoundly difficult because one is seldom comparing even the same kinds of apples and pears. At least one thing is clear – New Zealanders are not taxed highly by international developed country standards.

Thinking outside our current system

The Group will inevitably consider a wide range of possible changes to the tax system given that we may expect those to be suggested in submissions. The Submissions Background Paper outlines the most commonly suggested of these. I emphasise that the fact that some are mentioned and not others is not an indication of any prejudgment on our behalf.

Some options – notably inheritance tax and capital gains on the family – are outside the terms of reference. That leaves possibilities for discussion ranging from financial transactions taxes, wealth taxes, and equalisation taxes through to a more generalised capital gains tax, land tax (but again already excluding land under the family home), and environmental taxes. We are also likely to discuss the use of hypothecated taxes even though officials seem to believe the words hypothecate and apoplexy have the same ancient Greek root.

Implicit in our terms of reference is the notion that whatever the package - or packages - of proposals that we come up with they will be roughly fiscally neutral. The one caveat I would add personally to that is that they must be capable of sustaining somewhat higher levels of spending if that is considered necessary or desirable by future governments and their electors.

Specific challenges

The final section of the background paper goes into a little more detail on the specific challenges that the terms of reference have posed for us. These cover housing affordability, capital gains tax, land tax, progressive company tax, environmental taxes, and removing GST from particular goods. I have covered what I need to say about those at this stage already.

Conclusion

The Tax Working Group has a very large task in front of it. Any tax system creates large vested interests that will oppose change. Any change to a tax system is easily misrepresented as a tax grab, an ideological lurch, unfair, unworkable or all of these. New Zealand has some deeply inherited cultural – one might almost say atavistic – attitudes to tax.

At the same time we want a civilised society. Our media (both social and traditional), many and varied pressure groups, and even the recommendations of our Coroners are full of direct or indirect calls for more government spending to achieve that and to widen its compass. There is less consensus on how to pay for it.

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