Tax Working Group Public Submissions Information Release

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Tax Working Group submission

The Future Environment

The main challenge for our tax system is to ensure resources are allocated efficiently to lift productivity, since productivity is what determines long-run per capita income and living standards.

Our tax system also needs to be more equitable both horizontally and vertically. It needs to ensure current and future revenue needs are met efficiently and equably.

In relation to the Maori economic base, it is helpful to recognise that the Treaty of Waitangi confers equal not different rights on Maori. These rights are based on common law and Magna Carta principles (Article 2) and equal rights as Crown subjects under Article 3.

The tax system is inequitable for many Maori because of the absence of a capital gains tax as it affects housing affordability. The inalienable nature of much Maori land means owners are precluded from realising tax-free capital gains on land asset sales. Implementation of a comprehensive capital gains (CCG) tax would address this anomaly.

Purposes and principles of a good tax system

<u>Principles for assessment</u>

The key assessment principles for a good tax system are efficiency, equity, revenue integrity, and the contribution the tax system makes to resource allocation that enhances productivity growth.

<u>Defining 'fairness'</u>

Fairness is largely determined by horizontal and vertical equity. A fair system would look similar to what New Zealand has now, plus a CCG tax, and the alignment of top income, trustee and company tax rates.

The current New Zealand tax system

<u>Frameworks</u>

New Zealand's broad-based, low-rate system should be maintained and enhanced. Maintaining its efficacy and efficiency requires continuous improvement, for example to deal with changes in technology, working life, and new business models.

Enhancement requires a CCG tax, and potentially some extension of taxes to change behaviour.

It is also desirable to align the top personal income, trust and company tax rates. The existing company tax rate encourages tax sheltering arrangements, and this is both inequitable and leads to resource misallocation.

Some will argue for a lower company tax rate on international competitiveness grounds. However, OECD company tax rates have tracked down dramatically since the mid-1980s and yet there is no evidence this has lifted total factor productivity.

Others will propose a drop in the top personal income and trustee tax rates to achieve alignment with the company tax rate. However, it is difficult to see how sufficient revenue from other taxes could compensate for the resulting tax foregone.

The other way to achieve alignment would be to lift the company tax rate to the 33% top marginal rate for income and trustee tax. This would mean our company tax rates would be near the top of the OECD. Taken in isolation, a 33% corporate tax rate may discourage FDI and reduce capital investment. It is assumed that it would also lead to shifting tax bases offshore to countries with low company tax rates.

However, a nation's competitiveness arises from its overall tax structure, its institutions, resources (including human and natural capital) and how it allocates its resources. Much New Zealand business is foreign-owned, so a disproportionate share of a higher company tax rate would be borne by offshore shareholders. Aggregate capital investment might drop but capital productivity might be enhanced on a smaller capital base. It is possible that IT advances, domestic legislation and international agreements might progressively reduce businesses' ability to avoid New Zealand company tax.

It is suggested that the macro-economic, competitiveness, and tax incidence effects of a 33% company tax be tested through modelling.

Taxes and behaviours

Excise taxes on 'bads' such as tobacco and alcohol are valuable. There may be some modest scope for their extension.

Environmental taxes can change behaviour. However, New Zealand already has fuel tax and road user charges, and climate change challenges may be best addressed through regulatory interventions and emissions trading. It is difficult to see how tax instruments might be applied to biodiversity, pest control, erosion, "green space" issues, or non-point water pollution challenges.

Environmental taxes therefore have significant limitations in the New Zealand context.

Retirement savings

Most OECD countries have compulsory savings systems in place for retirement saving purposes. Tax incentives might lift private retirement savings but reduce government savings – yet it is total national savings that matter for us.

While it is outside the scope of the Tax Working Party, compulsory savings as part of retirement policy is almost inevitable in New Zealand, given demographics and the unsustainability of existing superannuation provisions.

New Zealand has low domestic savings rates and this, coupled with capital misallocation, explains much of our deindustrialisation, poor productivity, weak tradeable sector performance, stagnating living standards, and the social tensions these give rise to.

Policies to lift savings must focus on economy-wide productivity. Retirement savings can lift aggregate savings, reduce the real exchange rate, and lift the capital to labour ratio, thereby boosting labour productivity.

The Superannuation Act 1974 put in place compulsory savings to supplement a universal pension scheme. Had this Act not been repealed, New Zealand would be far better off now. Ironically, making Kiwisaver compulsory and lifting the contribution rate would get New Zealand close to its 1974 policy settings.

Tax incentives to encourage retirement savings would be a political distraction from a much more important policy change that New Zealand needs – some form of compulsory saving.

The results of the current tax system

<u>Fairness and balance</u>

The tax system currently favours the speculative economy and in effect undermines the productive economy. This balance can only be addressed through a CCG tax, top marginal tax rate alignment, and other policies such as compulsory savings.

<u>Tax and business</u>

New Zealand has made good progress in minimising compliance costs. Continuous improvement is needed, including through making effective use of digital and other technology.

The tax system has some modest implications for maintaining natural capital. Lack of a land tax is probably environmentally beneficial. Inalienable Maori land creates incentives for long-term sustainable use, since owners do not have the option of selling land to realise capital gains. A capital gains tax might have some lock-in effects on land ownership, and lead to owners taking more of a longer-term sustainable approach to managing their land assets.

Some business forms benefit from low effective tax rates for a range of reasons. Some 'charitable' businesses are tax advantaged, as are land and rental property owners. Divergence between the top income, trust and company tax rates, and structures such as PIEs create inequities.

Thinking outside the current system

The main inconsistencies are lack of a CCG tax, and the divergence between top income, trust and company tax rates. The most important to address is capital gains.

Some new behavioural taxes might be justified, but they will have minor revenue effects.

Hypothecating tax revenue misaligns revenue and means it is spent inefficiently. Wealth taxes are ineffective, and are on the way out in OECD countries. They should not be further considered.

Specific challenges

Housing affordability

High net inwards migration and restrictions on new housing developments are the main causes of low housing affordability and related social depravation. However, housing costs are also inflated by the lack of capital gains tax on rental property and associated speculative housing investments. A CCG tax would have a modest but positive effect on housing affordability.

Capital gains tax

A CCG tax is justified on horizontal and to some extent vertical equity grounds. There are also strong productivity arguments favouring such a tax.

New Zealand's relative economic decline since the early 1970s and its stagnating productivity largely results from its low domestic savings rates and from capital misallocation. The absence of a capital gains tax means scarce domestic savings are invested in inflating the price of existing inelastic assets such as farmland and housing rather than in wealth-creating business growth.

Capital misallocation reduces productivity and therefore living standards. For example, current tax rules mean that farmers have incentives to pay interest rather than to pay tax. They have incentives to borrow money to buy more land, and to recoup the cost in future through tax-free capital gains. In 2017 this misallocation saw around $40 billion in on-farm debt alone in the dairy industry. How much better off we would be if such capital was applied to new wealth creation and economic diversification!

The main economic impact of a CCG tax will be to improve capital allocation in the economy, and therefore lift productivity.

Land tax

While fine in principle, a land tax is probably not feasible in New Zealand because there would be too many politicised claims for exemption. These exemptions would likely include residential land, the conservation estate and Maori land.

The only significant productivity benefit might be to encourage lifestyle property owners to make more economic use of their land; however this putative benefit is not guaranteed and could only be marginal. A land tax imposed on lifestyle blocks owners might have negative environmental impacts, for example encouraging a switch from protected natural areas to more intensive farming operations.

Environmental taxation

Environmental and other taxes to change behaviour are supported. However, there are significant attribution problems and compliance cost challenges. Given New Zealand's industrial structure, the revenue gains from environmental taxes would be minimal.

Progressive company tax

We should not romanticise the contribution of small businesses to the economy. If anything, the international evidence suggests that larger businesses are more productive than smaller ones. Even start-up and venture capital-supported businesses are typically based on ideas, technologies and skilled people from either larger businesses or public research institutions.

Progressive company tax would increase the complexity of the tax system, and would be gamed by businesses. It should not be supported.

GST exemptions for particular goods

Our GST system is broad-based and efficient. The only exemptions should be for goods or services where GST cannot be levied efficiently. Beyond this, exemptions for other particular goods would encourage political lobbying based on questionable public good or other analytical grounds. For example, would exemptions for food include luxury foods? Who defines 'luxury'? If healthy foods were exempted, who would define whether a particular combinational food such as an apple pie, muesli bar or fruit ice cream was healthy or not?

Exempting specific goods from GST would increase administrative costs and reduce revenue, with negligible public benefits.