CONSULTATION/INLAND REVENUE DRAFT LONG-TERM INSIGHTS BRIEFING

Stable bases and flexible rates: New Zealand's tax system – a summary

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Inland Revenue
Te Tari Taake

Introduction

1. This document provides a summary of Inland Revenue's draft Long-term Insights Briefing (LTIB), *Stable bases and flexible rates: New Zealand's tax system*.

2. The purpose of the draft LTIB is to explore the implications of rising fiscal pressures for New Zealand's tax system and what changes could be made to the tax system to enhance fiscal resilience.

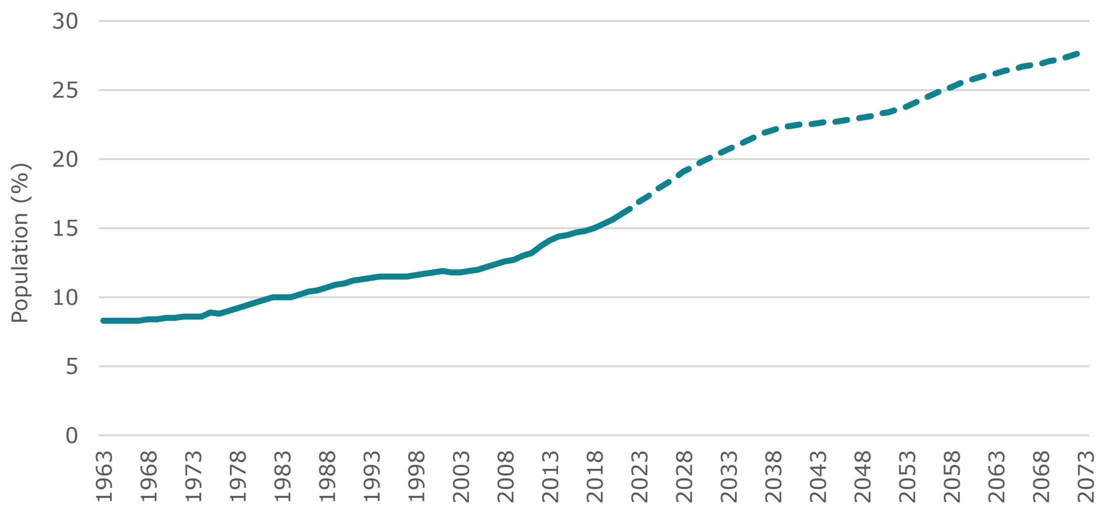
3. This is an Inland Revenue document and does not represent Government policy. We are seeking your feedback on the LTIB because we are interested in what you think about how New Zealand's tax system can adjust to rising fiscal pressures.

Rising fiscal pressures

4. By rising fiscal pressures, we mean that over coming years, if governments maintain current policy settings, government expenditure as a proportion of the economy will rise. The size of the economy is typically measured using gross domestic product (GDP).

5. A core driver of these fiscal pressures is that New Zealand's population is ageing. Figure 1 shows that by 2060 a quarter of New Zealand's population will be aged over 65. This means that the amount the government needs to spend on superannuation and health care will increase if the government maintains current policy settings. In its last Long-term Fiscal Statement, the Treasury predicted that government expenditure will exceed government revenue by 13.3% of GDP by 2061 if the Government takes no response to rising fiscal pressures.

Figure 1: Proportion of total population over 65, 1963–2073



Source: Statistics New Zealand (2022)

Role of tax system

6. The tax system is essential to the wellbeing of New Zealanders. Its core role is to raise sufficient revenue to fund government expenditure. A well-designed tax system would do this in a way that is broadly fair and imposes as low a cost on the economy as possible (that is, it is efficient).

7. If government expenditure-to-GDP increases in the future due to the ageing population and other factors, the amount of revenue raised as a proportion of GDP will also need to increase.

8. It is not necessarily the case that government revenue-to-GDP will increase in the future. Governments have choices as to how to address long-term fiscal pressures. They could, for example, make changes to the expenditure settings that are driving long-term fiscal pressures to reduce expenditure growth.

9. However, the future is uncertain, and we think that the tax system needs to be designed in a way that if expenditure-to-GDP did increase then revenue could similarly be increased in a way that is both fair and efficient.

10. We call this having a flexible tax system. A flexible tax system has the ability to increase the amount of revenue raised as a portion of the economy if government expenditure increases but in a way that society accepts as broadly fair, and that keeps the efficiency costs of raising tax as low as possible.

11. While having the flexibility for revenue to adjust to changing expenditure needs is important, it is also important for the core structure of the tax system to be reasonably stable over time. This allows businesses and individuals to plan for the future and avoids imposing unexpected losses or windfall gains.

12. Given these considerations, Inland Revenue thinks the tax system will be best placed to meet future expenditure pressures if it is designed to have:

    - a stable core structure of main bases that comprehensively taxes the factors that are sought to be taxed, and
    - the ability to change rates on main bases to change the level of revenue raised in a way that is fair and efficient (**flexibility**).

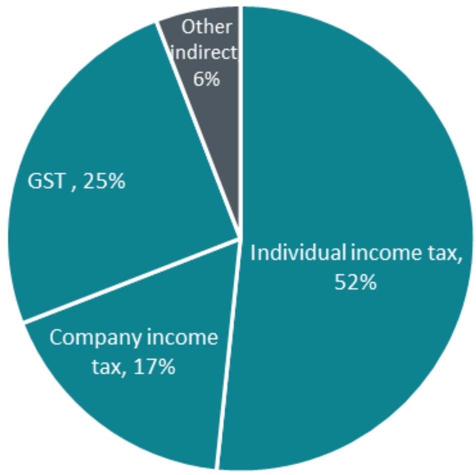
13. Under this approach, the suitable set of main bases for New Zealand would not depend on the revenue level. Rather, the core structure would be designed to adapt to changes in revenue needs over time.

14. Our LTIB explores these two ideas – a stable core structure with flexibility to alter rates on main bases to adapt to changing revenue needs.

Stable core structure of tax system

15. The tax systems of OECD countries rely on taxes on income and consumption for the majority of tax revenue. This is also the case in New Zealand where there are two main bases: income tax (on individuals and companies) and GST, a value-added consumption tax (Figure 2). These two tax bases raise over 90% of central government revenue in New Zealand (that is, not including revenue from local government).

Figure 2: Sources of revenue as a percent of core Crown tax revenue, 2023

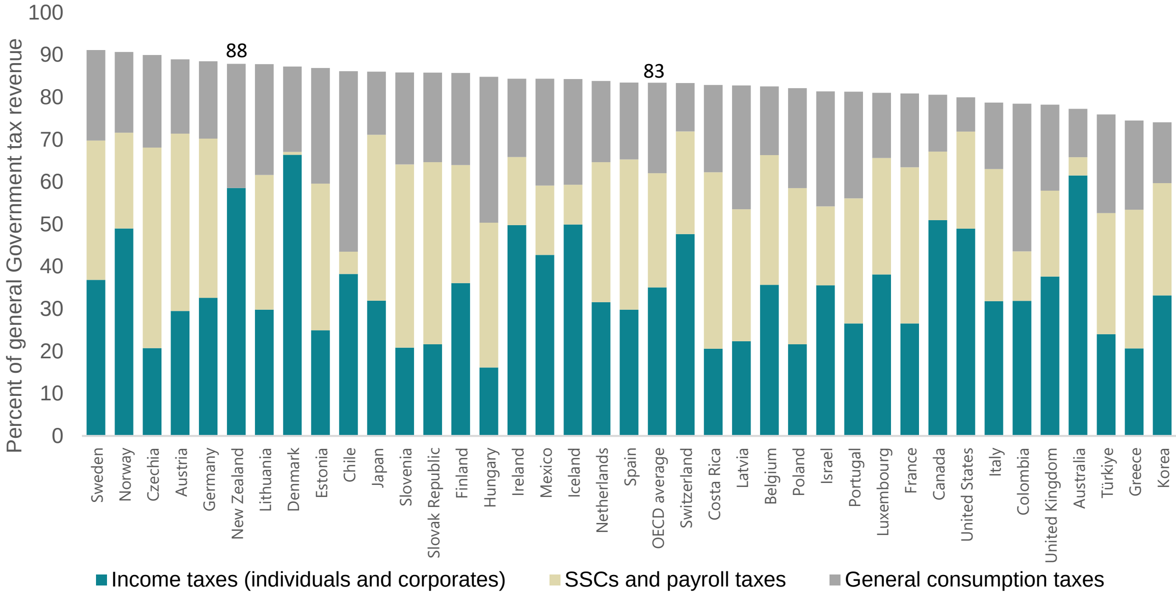


Source: The Treasury (2024)

16. Other OECD countries also typically have an income tax and general consumption tax. But it is common in the OECD to also have a main tax base that only applies to labour income. This is often in the form of a social security contribution (SSC) tax. SSCs can differ from other taxes because payment of the SSC usually entitles the payer to receive a social security benefit. The composition of tax structures varies considerably across OECD countries. As shown in Figure 3 below, New Zealand relies more on general income taxes than is the case for many other OECD countries.

17. This discussion highlights that a key choice in tax design is what main bases should constitute the tax system and that different countries make different choices on tax structure. To understand the effects of these choices our LTIB seeks to understand what **underlying economic factors** are taxed under different main tax bases. Thinking about tax bases in this way highlights the overlaps and differences between different tax bases and helps in thinking about the appropriate tax mix.

Figure 3: Sources of revenue as a percent of general government tax revenue, 2021[1]



Source: OECD

18. In general, we can think of tax bases as taxing the underlying economic factors of:

- labour income – income from working
- capital income – income from savings, which can be separated into:
  - the return from delaying consumption (normal return)
  - the return from risk-taking, and
  - returns in excess of these returns (economic rents).

19. Applying this framework to the main tax bases used in OECD countries of an income tax, consumption tax and a labour income tax, shows that all three of these taxes ultimately tax labour income in the same way. While a consumption tax is levied on spending, labour income is effectively taxed when spent.

20. However, these taxes differ in how they tax capital income. Only an income tax seeks to tax the normal return to capital. Note that within OECD countries there are different forms of income tax. New Zealand's general income tax seeks to tax capital income at the same rate as labour income, whereas a dual income tax (such as exists in Norway), has the same base as a general income tax but seeks to tax the normal return to capital at a lower rate than labour income and economic rents.

21. Either an income tax or a consumption tax will tax returns to capital in excess of normal returns. However, because a labour income tax only applies to labour income, it does not tax any return to capital income.

[1] General consumption taxes include value-added taxes and sales taxes but not specific consumption taxes that apply to particular goods and services. Figure 3 is based on general government tax revenue so includes local government rates as a revenue source for New Zealand.

22. Table 1 summarises the factors taxed under a labour income tax, income tax and a consumption tax.

Table 1: Comparison of labour income, income, and consumption tax

	Labour income tax	Income tax	Consumption tax
Labour income	✓	✓	✓
Capital income			
Normal returns	×	✓	×
Economic rents	×	✓	✓

23. The tax base can also affect how returns to risk are taxed. However, this also depends on whether there are progressive tax rates and if gains and losses are treated symmetrically. With flat marginal tax rates and full loss offsets, neither an income tax nor a consumption tax would disincentivise risk-taking. A labour income tax does not tax returns to risk from savings. However, income taxes generally have progressive rates and loss limitations that can discourage risk-taking. This gives rise to a trade-off between efficiency and equity goals.

What factors do we want to tax?

24. While it is relatively straight forward to explain what different tax bases tax, a much more difficult question is what should be the balance of taxation of underlying economic factors, that is, what should be the tax mix. This is a question on which there is much debate and controversy and involves weighing different considerations.

25. Most tax systems rely heavily on labour income. Taxing labour income is necessary for revenue sufficiency and is one way to align the tax system with the concept of ability to pay (those with greater incomes should contribute more). Therefore, any feasible tax system for the future must include substantial taxation of labour income.

26. Similarly, taxing economic rents (returns above the return needed to induce people to save or invest) helps align the tax system with the concept of ability to pay. It can also provide a relatively low-cost way to raise tax revenue because economic rents provide a return above what was required to induce people to save or invest. Because economic rents and labour income may often be substitutable, there are good reasons to tax economic rents at similar rates to labour income.

27. There is more controversy over the level of taxation that should apply to normal returns. The argument is that the normal return is simply the return from delaying consumption so taxing it results in a higher tax rate on consumption in the future than the present. This is shown in Table 2, which assumes a normal return to savings of 4%.[2] Spending $100 in year 1 is equivalent in a present value sense to spending $104 in year 2. So, taxing the 4% normal return on savings reduces the present value of consumption that could take place in year 2.

[2] Assuming no inflation.

Table 2: Consumption choices over time are neutral if no income tax

	Year 1	Year 2
Nominal values	**A** earns $100 labour income.	If **A** saves and earns the normal return, **A** now has $104 to spend.
Present values	If **A** spends this year the present value of consumption is $100.	If **A** spends $104 this year the present value of consumption is $100.

28. This idea leads to the conclusion that taxing the normal return results in a variable consumption tax, that is, a consumption tax where the rate depends on when an individual undertakes consumption. A variable consumption tax would have higher economic costs than a non-variable consumption tax.

29. However, many arguments have been raised in favour of taxing normal returns. One argument arises from considering the transition impacts from moving from one tax system to another. If taxes on normal returns were to be reduced, this would give a windfall gain to those who are currently wealthy. This might be considered unfair but also is not an efficient tax reduction. Other arguments in favour of taxing normal returns are that taxing capital income can serve as a way of taxing those with greater ability to pay or is justified when taking account of life-cycle effects and neutrality with human capital investments (study).

30. While there is no clear consensus on what the tax mix should be, we consider that the balance of economic opinion supports levying some tax on normal returns to savings earned by domestic residents, albeit potentially at a lower rate than applied to labour income and economic rents.[3]

31. Given this, Inland Revenue considers that basing New Zealand's tax system on the two main bases of an income tax and a value-added consumption tax provides a balanced approach to navigating these concerns. Such a system provides:

- two broad bases from which to raise revenue
- a base that can easily be made progressive, and
- retains the ability to tax normal returns while allowing for the tax mix to be shifted more or less to labour income and economic rents through the choices about the level of consumption tax.

32. Given this conclusion, Part 2 of the LTIB focuses on two issues:

- how to increase the flexibility of New Zealand's income tax and GST to changing revenue needs, and
- the pros and cons of adding alternative smaller bases to this tax mix.

[3] Note this discussion has focused on the taxation of domestic residents' income. Different considerations apply to the taxation of income from non-resident investment in New Zealand.

Flexibility of New Zealand's main bases

33. We define revenue flexibility as the ability to raise more revenue from a tax base without undue equity or efficiency cost. Inland Revenue considers that there are different issues with the income tax and GST base that currently limit the flexibility of these bases.

Income tax

34. New Zealand's income tax seeks to tax all income of New Zealand residents at the same rate. This means that both labour and capital income, and income earned directly or through entities, is intended to be taxed at the same rate.

35. However, New Zealand's income tax system can result in significant variation in the tax rate applying to income depending on how the income is earned. This reduces the flexibility of the income tax to adapt to changing revenue needs because it provides opportunities for individuals and businesses to structure their affairs in a way that reduces tax paid. It means that when the government attempts to increase revenue through increasing tax rates on personal income, some of the intended revenue increase is lost as people restructure their activities into lower taxed forms.

36. Some of this variability arises because a real-world income tax will never fully tax "economic income" comprehensively for practical reasons, such as to keep compliance costs low. For example, it is generally not practical to tax capital gains as they accrue even though they are economically income.

37. However, some of this variability relates to choices New Zealand has made. Two issues the LTIB focuses on are:

    - Comprehensiveness of the income tax base – New Zealand taxes a more limited set of capital gains than most other OECD countries.
    - Integration of the personal and company tax system – having a company tax rate lower than top personal rates allows individuals to obtain lower tax rates by earning income through companies.

38. While these issues would be mitigated if New Zealand set the top personal rate near the company rate, Inland Revenue does not think this "aligned" model will provide a durable tax system going forward. It is important that the company tax rate not be so high as to unduly discourage foreign investment. Revenue sufficiency and equity considerations suggest that the top personal rate should not be too low. These point to top personal rates being above the company rate for many future governments. Hence, a durable tax system for the future needs to be able to tolerate a gap between the company rate and top personal rates.

39. Inland Revenue considers that New Zealand has two broad choices to increase the flexibility of the income tax:

    - New Zealand could continue with a general income tax that seeks to tax all income at the same rate. Revenue flexibility could be increased through broadening the scope of capital gains taxed and implementing mechanisms that seek to tax income earned through entities at as close to personal tax rates in a present value sense as is possible.

However, this approach will never fully eliminate the variability in tax rates applying to income given there are practical constraints on taxing income comprehensively.

- New Zealand could investigate a dual income tax. A dual income tax is an approach that seeks to tax the normal return to capital at a lower rate than labour income and economic rents. It is an approach that is used in Norway. A dual income tax still requires taxation of capital gains to work. However, in the LTIB we explore whether a dual income tax can provide for better integration of company and personal taxation than New Zealand's current system does.

40. We are interested in submitters' views on constraints and solutions to increasing the flexibility of New Zealand's income tax to changing revenue needs.

Consumption taxes

41. The LTIB looks at different choices for consumption taxes for New Zealand and concludes that a value-added consumption tax (VAT) remains the best approach for consumption tax going forward.

42. New Zealand's broad-based GST provides a relatively efficient base from which to raise revenue. However, because GST applies at the business level the rate cannot be set in a way that increases with individuals' income or consumption, it is not a progressive tax. In New Zealand GST is levied at a flat rate on almost all supplies of goods and services.

43. If the rate of GST were to be increased to meet higher future revenue needs, there would be concern as to how this tax increase affects those with lower incomes. An increase in GST may reduce the ability of lower-income households to purchase necessities, having a relatively large impact on the wellbeing of low-income families. The LTIB therefore explores approaches to ensuring that revenue raised from a GST increase is raised from those with higher rather than lower incomes.

44. There are two broad measures that could be implemented alongside a GST rate increase to reduce its effect on lower-income groups:

- separate lower rates could be applied to certain goods and services that form a large part of the consumption basket of lower income households, and/or
- cash transfers could be used to offset the effects of a GST increase on lower-income households.

45. There are several downsides to the first approach. It would:

- provide the largest absolute benefit to higher-income households
- create significant compliance and administrative costs, and
- be unlikely to be fully passed through to consumers.

46. Several international and New Zealand-focused studies have shown that using cash transfers is a more cost-effective way to target assistance to lower-income groups compared to applying lower rates to certain goods and services. Several countries have implemented permanent GST-offset schemes for this reason.

47. The effectiveness of transfers would depend on their design. Two issues are the ability to target transfers at those in need and the effect on work incentives if the transfer applies below an income threshold.

48. We have undertaken a modelling experiment to understand the effects of increasing the GST rate by 3-percentage points and then redistributing some of the revenue raised back to low-income families through a GST offset credit. Our modelling shows that such an approach can be broadly effective in insulating low-income families from the GST rate increase but highlights there are difficult trade-offs between targeting precision and implementation simplicity.

Alternative bases

49. Chapter 6 considers the desirability of adding alternative bases to New Zealand's tax system. If the tax system is designed around a stable core structure of bases that seeks to comprehensively tax the factors sought to be taxed, with the flexibility to alter rates on main bases to meet changing revenue needs, then the best way to consider the desirability of new bases is by comparing their efficiency and equity effects from raising a given level of revenue to existing bases.

50. The bases we assess are payroll tax, wealth tax, inheritance tax, land and property tax, and social security contributions. Our analysis shows that all these bases (except perhaps an inheritance tax) overlap with existing bases in terms of the underlying factors they tax. There are difficult trade-offs to consider for each of these alternative bases. Table 3 summarises the equity and efficiency effects of these bases.

Table 3: Comparison of alternative tax bases

Tax base	Pros	Cons
Payroll: Taxes labour income of employees.	Keeps the tax impost on normal returns to savings low, which may support efficiency.	Overlaps with GST. GST is better at targeting labour income and taxes economic rents that are untaxed under a payroll tax. GST likely has efficiency and equity advantages over a payroll tax.
Wealth: Taxes capital income but exempts above normal returns.	Could be seen to tax income that cannot be, or is not, effectively taxed under income tax. Increases progressivity of the overall tax system.	Can have high efficiency cost because it results in relatively high tax rates on normal returns and has high compliance costs. Could be seen as vertically inequitable because it does not tax excess returns. A broad income tax has important advantages over a wealth tax.
Inheritance: Taxes either recipients or estates.	Could be seen to improve equity and have relatively low efficiency costs.	Tends to yield little revenue and can have high compliance costs.

Tax base	Pros	Cons
Land: Recurrent taxes on gross value of unimproved land.	Relatively efficient tax. Low administration and compliance costs. More efficient than property taxes or stamp duties.	Could be seen as unfair because it imposes a lump sum tax on those who own land when introduced. Overlaps with local government rates. Special considerations apply for Māori land.
Social security contribution: Levied on wages and can be linked to a benefit like superannuation.	Could have lower efficiency costs if individuals see SSCs as funding a benefit such as superannuation.	For New Zealand, SSCs overlap with KiwiSaver, which already provides an approach to private savings.

Conclusion

51. New Zealand faces difficult choices in designing a durable tax system in the face of long-term fiscal challenges. In Inland Revenue's view, a priority for future work should be on how to make New Zealand's main bases of income tax and consumption tax more flexible to changing revenue needs over time. Our LTIB explores a number of options to do this.

52. We are interested in your views on how to ensure our tax system is durable in the face of long-term fiscal pressures. Page 9 of the draft LTIB includes a number of questions to guide responses and details on how to make a submission.