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MINISTRY OF BUSINESS, INNOVATION & EMPLOYMENT
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MBIE SUBMISSION TO TAX WORKING GROUP, APRIL 2018

1 MBIE's submission to the Tax Working Group consists of two parts:

a. General comment; and

b. Five thematic perspectives for consideration in designing the tax system, drawing on MBIE's expertise in policy areas we are responsible for:

- investment
- urban development and housing
- labour markets and the future of work
- research, science and innovation
- consumers.

2 The submission reiterates and adds to earlier material that MBIE has provided to the Tax Working Group. The earlier material includes a presentation to the Group in February 2018 about the changing New Zealand economy and input to the Tax Working Group Secretariat in response to discussion documents prepared by the Secretariat. Further material can be provided to support this submission if the Group or the Secretariat would like to follow up on any of the points raised.

PART 1: GENERAL COMMENT

Tax system as one of a suite of levers

3 The ultimate purpose of public policy is to improve wellbeing and living standards of New Zealanders. The tax system is one of the levers that can help pursue this purpose.

4 The tax system plays an important role in shaping a productive, sustainable and inclusive New Zealand economy. For example:

a. Tax settings can enhance or detract from New Zealand's productivity performance, for example, by (dis)incentivising firm growth, impacting on the allocation and use of capital, or changing the industrial structure of the New Zealand economy.

b. In supporting sustainability, the tax system is one mechanism by which environmental or social externalities may be internalised, levelling the playing field across the economy.

c. The tax and transfer systems have a redistributive role. The broader design of the tax system can also have significant distributional impacts across a range of dimensions including across regions, incomes, gender and ethnicity.

5 The tax system needs to be considered alongside the full suite of levers that are available to achieve the government's economic, social and environmental objectives. Taxes alone cannot achieve all the objectives sought but, if carefully designed, the tax system can complement non-tax regulatory and other policy settings to improve the overall living standards of New Zealanders. It is important that the policies – both within the tax system and across tax and non-tax levers – drive behaviour in the same direction to improve living standards. For example, to change investment patterns requires a strategy co-ordinating tax and non-tax regulatory settings, funds and grants and government signals.

Future challenges and changes

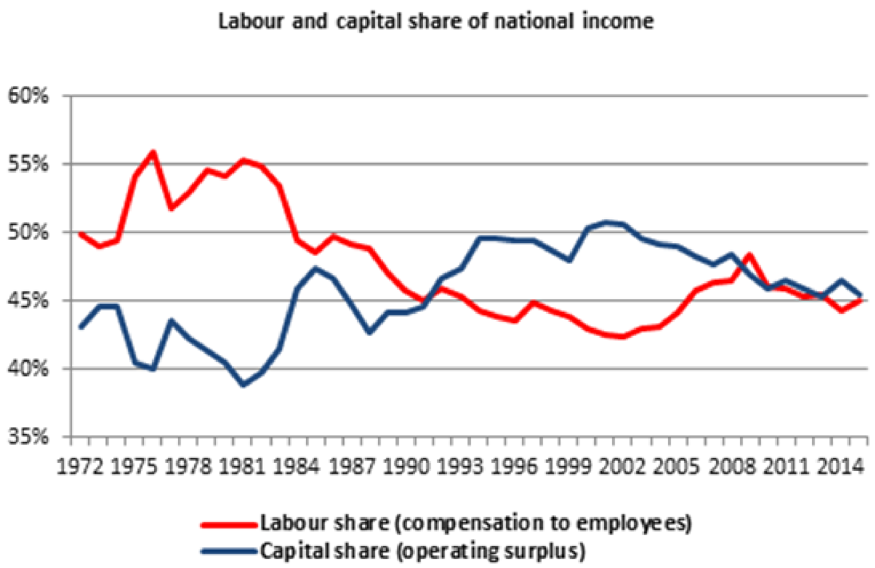
6 The design of the tax system must consider future challenges and changes in New Zealand's economy and population. Disruptive economic change will occur as a result of technological advancement, globalisation, climate commitments and other megatrends. The tax system needs to be designed with this in view, so that it is sufficiently flexible to sustain the government's revenue base as the economy changes (which could be different to current expectations). The Tax Working Group Submissions Background Paper rightly identifies this need.

7 The rapid growth of the digital economy is a particular challenge. The presumption that income should generally be taxed in the places where the activities, or the underlying assets, are located could become increasingly difficult to apply. In a highly globalised world, the location of physical assets becomes far less relevant to generating income. Tax policy will need to continuously adapt to changes in markets and how taxpayers engage with them.

8 Technology is also facilitating a change in business models. For example, the 'sharing economy' and the 'gig economy' are growth areas globally. The sharing economy monetises underutilised assets (eg spare rooms) as the growth in online marketplaces have enabled ordinary people to compete easily with companies. The sharing economy covers a wide spectrum of business models from the commercially oriented Uber and Airbnb, to ones that build local social capital like Neighbourly. The gig economy (which includes many sharing economy businesses) is increasing the casualization of the labour market. Workers in a gig economy get paid for the 'gigs' they do, eg IT micro tasks, as opposed to a regular salary or wage. Importantly, the gig economy labour market is increasingly operating across jurisdictional boundaries.

9 Uptake of these business models still appears modest in New Zealand but is expected to grow. The implications for the tax system are that these models often involve taxation outside of our jurisdiction.

10 In addition, people are increasingly likely to work multiple small contracts, instead of holding 'one salaried job', and enter into more complicated employment arrangements (see Part 2 for more details). The graph below shows long-term historical trends of labour and capital share of income for New Zealand. The falling labour income share reflects wages growing more slowly than returns to capital. The labour share of income may continue to decline. In sum, future changes in the labour market are likely to affect the revenue base and make the administration of the wider tax and welfare system more complex. Enabling the tax system to respond to changes in the way New Zealanders work will also be critical for New Zealand's success.



11 More generally, the nature of business activity is changing and will continue to change. New Zealand businesses are moving into more knowledge-intensive sectors and seeking to move up value chains. On top of this, New Zealand has insufficient domestic capital readily available to finance our investment needs and must therefore compete for high quality foreign investment. The future competitiveness of New Zealand's business environment will be highly influenced by tax and non-tax regulatory systems.

12 New Zealand is becoming more diverse, which suggests there is no form of generic 'kiwi' business culture. This diversity may have implications for how well understood the tax system is, as well as compliance and enforcement.

Population and gender considerations

13 Design of the tax system must also consider the implications on different population groups, particularly Māori and Pasifika given they are disproportionately disadvantaged groups of our population. In the workforce, Māori and Pasifika are over-represented in lower-skilled jobs – 28 per cent and 32 per cent respectively, versus 13 per cent being European, in 2017. This may affect the incentives for people to upskill, given the impact of marginal tax rates.

14 New Zealand's changing demographics are expected to result in an ageing European population and a larger proportion of young Māori and Pasifika. This adds weight to the suggestion that the tax base needs to be broadened, to avoid these population groups paying a disproportionate share of tax. In addition to growing the future Māori workforce and upskilling, the key opportunities for Māori and Pacific economic development are through growing Māori small and medium-sized enterprises, and maximising the economic value of iwi and collectives (total asset base of $15 billion). Any disincentive to this type of investment introduced through tax changes could make it harder to improve the living standards of these population groups.

15 The implications of taxes designed to influence behaviours also warrant examination of the impacts on these population groups, particularly given the proportionally greater concentration of these taxes in lower income brackets. For example, the regressive impact of tobacco taxes on lower income households would reduce the amount of money these households have for other goods and limit their other choices, including their housing aspirations.

16 There may also be a need to consider the distributional impact of some elements of the tax system on women. Important factors could include women's greater average life expectancy (currently female life expectancy at birth is 3.4 years higher than male life expectancy at birth), and the distribution across genders of income and wealth.

17 A recent Treasury Working Paper concludes that 'tax expenditures' in New Zealand may have a negative impact on gender equality.[1] Tax expenditure is any form of spending that is provided for through the tax system. Tax expenditures alter the tax system by allowing exemptions, deductions or credits to particular groups of people or for specific activities. These include Working for Families and KiwiSaver tax credits. Deepening the understanding of the impact of tax expenditures on gender equality, and considering options to address any impact, merits further attention.

Design principles for tax system

18 The tax system must be designed in a way that helps achieve the purpose of improving the wellbeing and living standards of New Zealanders. Changes to the system should focus on securing and maintaining the government's revenue base over time – it is about building a fair and resilient system, rather than seeking to increase tax revenues by capitalising on future changes in economic activity.

19 The tax system should, as far as possible, be neutral over the long term, meaning that different forms of income and different classes of assets should be taxed in a substantially similar way.

[1] Morrissey, S. (April 2018). Gender Budgeting: A useful approach for Aotearoa New Zealand. Treasury Working Paper 18/02.

Broad-based, low-rate principle

20 The Tax Working Group is considering whether the broad-based, low-rate design principle for New Zealand's tax system remains relevant. The low-rate aspect is intended to reduce the costs associated with taxation and the broad base reduces distortions between different forms of saving. There are arguments, however, that the base could be broader. For example, we have differential tax treatment of asset classes and no land or wealth taxes.

21 The rationale for the principle of broad-based, low-rate tax is strong as it emphasises efficiency, it minimises distortionary incentives and it acts to widen the potential pool of taxpayers as part of maintaining the revenue base.

22 However, it would be useful for the Tax Working Group to carefully consider implications for equity alongside the application of the broad-based, low-rate principle. This should pay particular attention to cases where the principle results in regressive tax arrangements or has disproportionate impacts on specific groups of people (as discussed in the previous section on population and gender considerations) or businesses.

23 The broad-based, low-rate principle can be combined with taxes aimed at modifying behaviour, by including the positive or negative spill-over effects into decision-making. There is some merit in exploring the case for taxes to encourage (or discourage) certain behaviours, particularly to ensure negative externalities are internalised. Such taxes need to be carefully designed to ensure they do achieve their intended effect – without unintended consequences – in a cost-effective way, and to be assessed in comparison to other feasible options for achieving the desired effect.

24 There may be considerable hurdles in changing behaviours, which a tax alone is insufficient to address. Some preferences may be embedded through culture, whether as current social norms, or long-held cultural values (for example, Māori cultural values for land; New Zealanders' interest in housing assets).

Other design principles

25 The principle of taxing different forms of income, and classes of assets, in a substantially similar way is sound, subject to consideration of other principles (collection and compliance costs). There is a risk that current differences in tax treatment across income streams and asset classes may distort investment choices, and may have significant long-term implications for the structure and performance of the New Zealand economy.

26 The Tax Working Group Submissions Background Paper describes previous criteria used to assess tax system changes against the design principles and also comments on the Treasury's Living Standards Framework as a possible tool for analysing the implications of tax system changes. Given the Government's intention to place intergenerational wellbeing of New Zealanders at the centre of policy, changes to the tax system should be similarly assessed. It is important to understand how taxes affect and could improve the living standards of New Zealanders. In particular, it is important to understand the potential interactions and trade-offs between the dimensions of current wellbeing and the four capitals when the tax system changes. This is a complex task and again emphasises the importance of considering the design of the tax system as a part of the wider suite of government policy options.

27 In taking a living standards approach, other criteria for assessing the performance of the tax system should also be considered, including the sustainability, transparency, and effectiveness of tax policy. Efficiency, including the compliance burden, is also an important consideration. Compliance costs should be minimised where possible. In assessing compliance costs, it is important to consider not only the costs of compliance with tax obligations, but also how tax compliance adds to total (tax and non-tax) compliance costs for businesses.

28 Any consideration of new taxes, such as a wealth tax, or a land tax, should be assessed within a living standards approach, with careful analysis of the impact on the overall wellbeing of New Zealanders.

PART 2: OVERVIEW OF THEMATIC PERSPECTIVES

29 This part of MBIE's submission provides perspectives on five thematic areas for consideration in designing the tax system. These are areas in which MBIE has particular expertise given our spheres of policy responsibility.

30 Although a perspective is presented for each sector, the issues raised cross over and taxes impact across the spheres. It will be important for design of the tax system to take a wide-ranging view of the effects of proposed tax policy changes and seek to minimise distortions and carefully consider incentives across the whole economy.

An investment perspective

31 New Zealand needs investment to deliver a dynamic, diversified, high-tech and low carbon economy that is inclusive. This would help deliver an economy that will help New Zealand not only to adapt to change, but to prosper in a fast-changing landscape.

32 The tax system currently incentivises investment decisions in New Zealand, from both domestic and foreign sources, into less productive parts of the economy. Our investment patterns can tend to entrench incumbent sectors and, in the short term, lift economic growth (GDP), but with no long-term benefit for productivity. For example, financial markets exposure is concentrated in the real estate and agriculture sectors – mortgages representing 50 per cent of bank lending. Further, capitalisation rules for banks favour mortgages on housing.

33 New Zealand has low saving rates compared to other countries. New Zealand's household saving rate has been negative for most of the last 20 years (although this may underestimate rising savings into houses, foreign assets and trusts), and New Zealand has shallow domestic capital markets. The root causes are not well understood, but possible causes may be:

- rapidly rising house prices and faster growth in mortgage debt relative to disposable income in many segments of the population
- policy settings (including tax) along with market environments potentially leading to distortions in the market and preferences for investment to flow towards certain types or sectors of investment.

34 One possible channel to increase saving by households is through retirement savings. The Tax Working Group Submissions Background paper notes that New Zealand's approach to the taxation of retirement savings differs from most OECD countries. In New Zealand contributions to retirement savings are made out of income that is taxed, the income earned from the investment is taxed, but the amounts 'withdrawn' are not taxed ('taxed-taxed-exempt' treatment). In most OECD countries it is only during the drawdown phase that taxation occurs, where the withdrawals and accumulated earnings are taxed ('exempt-exempt-taxed' treatment).

35 There is merit in reconsidering New Zealand's current treatment of retirement savings, to help minimise any serious distortions of investment choices created by New Zealand's differing tax treatment for different types of asset. This would need to be considered as part of the overall rebalancing of the tax system, and it would be important to ensure any changes incentivise increased saving and do not result in flows shifting away from productive sectors of the economy. It may be prudent to consider limitations on the amount that could be deposited into such schemes, to ensure that distributional consequences of a form of tax saving are minimised and that a shift into tax preferred-retirement savings does not substantially decrease tax take.

36 Current and new investments should move towards existing areas of competitive advantage and new markets, new products, new processes and new firms. Tax policy is a lever that could support facilitating investment towards the parts of the economy that are more productive. However, it is important to be wary of creating new distortions in the market.

37 Dis-incentivising investment from some unproductive sectors may not automatically drive that capital into more productive areas. Some things to consider in the design of the tax system are:

- ease of investing in a particular type of asset or sector – barriers to investment
- distortions in the market – unintended consequences, incentives or disincentives, and
- desire to achieve a balanced portfolio of investment across risky/non-risky assets and different markets (New Zealand vs foreign).

38 It is important that taxes do not dis-incentivise investment into particular sectors that drive transformation and diversification of the economy. Specifically, when considering capital gains taxes, there may be a need to consider the impact these would have on the operation of some markets, particularly where market failure characteristics would need to be addressed. The government has a range of options to do so, ranging from direct intervention through to exemptions. In this regard, it is important to consider:

a. Venture capital investment in early stage activity where risks are high and returns are mostly realised through capital gains. Venture capitalists must realise any capital gains to justify to their partners the risk of the investments and to invest into promising new ventures. Without venture capital funds, certain types of entrepreneurs and start-ups will not get off the ground.

b. Foreign direct investment, where there is strong global competition for high quality investment and where New Zealand's size, distance and the limited number of opportunities reduce the potential pay-back for investors to solve co-ordination and market information asymmetry issues.

c. General business decisions on expansion, choice of capital, lock-in (timing of when to sell and the need to recycle resources for optimum allocative efficiency), firm structuring and the impact this can have on distorting price signals.

39 Tax reform is just one of many levers that can be used to effect changes to investment patterns, and a co-ordinated strategy that aligns the levers is required. Other policy levers include the programmes of Crown entities (New Zealand Trade and Enterprise, New Zealand Venture Investment Fund, Land Information New Zealand), other funds (Provincial Growth Fund, Green Investment Fund), grants and subsidies (Large Screen Production Grants, Major Events Fund), non-tax regulatory settings and general government signals about where to invest.

40 In redesigning the tax regime and contemplating progressive business taxes, it is important to note such taxes may have impacts on incentives for businesses to grow (and indirect consequences for high-growth firms, exporters, employers) and on how businesses are structured.

41 Careful consideration should be given to the overall effective corporate tax rate and the imputation to shareholders, to ensure the system does not dis-incentivise foreign direct investment (and favour other types of investment flow). New Zealand has a relatively high effective corporate tax rate in comparison to 'competitor' peer countries which compete for foreign direct investment, but a relatively attractive rate for shareholders and dividend earners.

42 The Tax Working Group is examining the impact of a lower tax rate for small companies. Differential tax settings for business size can have distortionary effects on business behaviour which reduce benefits and appear to inhibit the development of high growth firms that transform the economy. Many countries have this system and there is some evidence that it can dis-incentivise small firms from expanding and can result in income-shifting around thresholds. From an equity perspective, this can penalise certain types of firms or certain sectors more.

Urban Development and Housing

An urban development perspective

43 The performance of the urban economy is critical to New Zealand's future prosperity given that cities will be a primary location for launching into new markets and creating new products, processes and firms. This relies on investment in skills and labour and on capital investment in new and existing firms, including those that build houses.

44 A tax system that incentivises investment in the purchase and trading of existing houses and land assets, and thus dis-incentivises investment into new and existing businesses (particularly those that are that are capital constrained) can affect the performance of the economy, and the urban economy in particular.

45 Successful urban development also relies on having adequate investment in growth-enabling infrastructure and ensuring urban land can flow easily to higher-value uses over time.

46 To facilitate these outcomes, consideration should be given to a land tax on the unimproved value of land. This has two potential benefits from a wider urban performance perspective:

- It incentivises landowners to develop their land to its highest and best use (eg intensify, or cease land-banking), and thus helps increase housing supply, among other benefits.
- It provides an efficient and relatively simple way of directly capturing a portion of the value uplift that can arise from infrastructure investment or planning changes, and directing that revenue into the investment that generates the uplift in the first place. This would help support the ability of central and local government (eg if it is hypothecated) to better plan for and support urban growth in New Zealand.

A housing perspective

47 MBIE has a high-level goal of reducing the ratio of housing costs to income, underpinned by a goal of increasing median income by 40 per cent by 2025, from $1,300 per week to $1,800 per week. To meet the housing cost-to-income goal, housing costs (whether that is households paying for their own home, or paying rent), need to increase by less than the increase in median income.

48 House prices have increased sharply in New Zealand over the past 15-20 years as demand has run up against insufficiently responsive supply. In recent years, rents throughout the country have also increased sharply. There are severe constraints on the supply of housing in many New Zealand cities. These constraints reflect the impact of various drivers, including land use regulation, geography, inadequate infrastructure provision, and low building sector productivity.

49 A range of factors have contributed to strong housing demand, including rising incomes, population growth, declining interest rates, declining average household size, and investor demand.

50 Investor demand is likely to have been amplified by New Zealand's tax settings, including the absence of comprehensive taxation of capital income and the ability to fully deduct interest expenses. In an environment of positive inflation, this allows leveraged investors to deduct the inflation component of interest expenses while accumulating the untaxed gains on the value of their property arising from general price inflation. The lack of a capital gains tax is likely to particularly amplify investor demand in sharply rising housing markets. The ability to deduct interest will be partly curtailed by the proposed loss ring-fencing rules for rental properties.

51 Owner-occupied demand is supported by the non-taxation of imputed rent, and the absence of taxation on capital income.

52 Investment is needed for new housing supply, and developing more efficient means of production. In a well-functioning market, where supply is responsive to demand, investment can also play a useful role in providing rental housing and helping establish price signals to inform new supply. The problem is that investment in housing, especially in a supply-constrained market, can lead to:

a. Price inflation – investors may have greater ability to pay than other prospective purchasers and can raise prices competing for scarce assets.

b. Volatility in house prices — speculative demand can increase housing above fundamental values (causing a bubble) or move it more quickly towards new equilibrium prices.

c. Crowding-out of some home buyers (ie different demand markets) – for example, first-home owner-occupiers cannot get on the property ladder if they are competing with investors who can use existing properties as leverage. Property wealth may therefore become concentrated over time in a narrower band of owners.

53 A tax-neutral investment environment will be beneficial in the long run, as this will incentivise investment to flow to the most productive sectors of the economy. There are opportunities to reform the tax treatment of housing that would increase the fairness and balance of the tax system overall. There is a range of potential tax options to address this, including a capital gains tax, changes to deductible taxes, changes on taxation of the inflation component of interest income, Risk Free Return Method for property and wider options that would incorporate housing such as land taxes and value capture.

54 A broad-based capital gains tax – ie levied neutrally on all forms of capital gain, not just in the housing market – would support the overall objective of investment neutrality. In the long run, it could also contribute to fairer intergenerational distribution of wealth.

55 In the short term, in the absence of an increase in overall housing supply, the effects of a capital gains tax — and especially one levied only on investment properties and not all properties— are highly uncertain, but could potentially reduce the supply of rental properties and increase rents. These effects could arise from:

- a shift in the existing stock of housing towards owner-occupation, reducing the supply of rental housing per remaining renter (given the tendency for owner occupied housing to have lower occupancy rates)
- less efficient utilisation of the housing stock due to lock-in, and
- reduced growth in housing supply over the longer term given likely reduced investor demand.

56 This could have regressive distributional impacts, even if the affordability of owner-occupied housing is improved. The potential effects need to be carefully researched and considered in the design and application of a possible capital gains tax.

57 For this reason, while a capital gains tax would be a potential option for an overall re-balancing of the investment environment, it will be critical to ensure there is a carefully managed transition pathway in the short term while the housing supply pipeline recovers on the back of wider government housing and urban development initiatives. This could include a clearly signalled lead-in time that aligns with the anticipated three-to-four-year ramp-up of KiwiBuild and government-led large-scale development activity, as well as the signalled changes to regulatory and other systems that affect housing supply.

58 MBIEs best advice would be to ensure neutrality of all forms of investment, including the family home. This is not available as an option as, under the terms of reference of the Tax Working Group, any capital gains tax would exclude the family home or the land under it.

59 One second best option could be to consider amending other measures (tax and non-tax) to reduce the incentive to over-invest in housing (whether rental or owner-occupied) and to increase the size and efficiency of capital markets in New Zealand. It would be worthwhile for the Tax Working Group to consider changing the tax treatment of alternative savings vehicles to housing.

60 This could include consideration of the tax treatment of bank deposits and retirement savings schemes, as discussed in the "Investment perspective" section. As Andrew Coleman[2] argued, this would move retirement savings more in line with the tax treatment of housing and erode the incentives that favour one form of savings over the other. Reducing taxes on alternative savings vehicles may also assist first-home buyers to save a deposit. The taxation of retirement savings could also be considered in this context to help move to a tax-neutral investment environment and improve the depth of capital markets, as discussed in the "Investment perspective" section of this submission.

[2] Coleman, A.M.G. (May 2017). Housing, the 'Great Income Tax Experiment', and the intergenerational consequences of the lease. Motu Working Paper 17-09.

61 There is inherently a trade-off in alternative investments between both maintaining neutrality with owner-occupied housing, and maintaining neutrality with other forms of investment. Encouraging neutrality with owner-occupied housing through a tax-preferred alternative savings vehicle, such as the ‘exempt-exempt-taxed’ treatment of retirement savings discussed in the section “An investment perspective”, may discourage over-investment in owner-occupied housing. However, this could create other distortions across other asset classes and would reduce taxation revenue. If such a system did not include sufficient limitations, these impacts on taxation revenue could be substantial.

62 Whether or not a comprehensive capital gains tax or land tax on the unimproved value of all land (excluding the family home or the land under it) is implemented, it would be worthwhile investigating value capture or cost recovery on specific projects. This could be through either the taxation system generally (and fall under the remit of the Tax Working Group) or through rates. These interventions would need to be planned together to avoid double taxation.

MINISTRY OF BUSINESS, INNOVATION & EMPLOYMENT
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A perspective on the labour market and future of work

63 To achieve the outcome of an increased number of highly skilled people and innovative firms, MBIE has high-level objectives of doubling labour productivity growth and reducing the unemployment rate to below four per cent. As part of this it is also important to lift wages and to ensure there is decent work and greater job security, more skilled, adaptive and resilient workers and lower under-employment.

64 The following labour market issues are likely to affect the government's current and future revenue base:

a. The labour share of income may continue to decline, reducing the proportion of personal tax revenue from future wage and salary earners. This could affect the tax base over the longer term – it is important that the tax system retains flexibility to respond to this.

b. Workers and firms may increasingly choose to enter into multiple, short-term, overlapping employment arrangements making personal tax obligations more difficult to predict, calculate and verify. These arrangements can also leave workers more vulnerable, with fluctuating incomes, raising questions of how best to protect workers in such situations. It will be important to closely monitor the extent to which these trends are emerging in New Zealand. For example, the proportion of employees with multiple jobs has declined since its peak in the late 1990s. But this may reflect New Zealand's relatively high under-utilisation rate of labour, which increased during the global financial crisis and has not yet trended down.

c. Firms may prefer to engage highly skilled workers as self-employed contractors rather than employing them as staff (more flexibility, easier to procure very specific skills). Such arrangements allow workers opportunities to net off costs against income more easily than is permissible within traditional contracts of service, hence reducing their tax liabilities. This is already an issue for the tax system. The proportion of self-employed workers has been relatively stable in New Zealand since the late 1980s/early 1990s, at around 12 per cent. Experience with the 'gig economy' in other countries suggests that this proportion may well rise in the future. If so, the differences between personal and company tax rates may lead to a decrease in the revenue base.

d. Highly skilled workers may increasingly work across national boundaries, either by commuting or better enabled by technology to work for overseas clients or employers. Income and tax obligations may more become difficult to verify in this situation.

65 The wider tax-transfer system (including student loans and allowances) is also likely to become more complex to administer over time, as a higher proportion of workers enter into more complicated employment arrangements (as described above) and as the economy responds to the impact of technology, globalisation, climate commitments, and other megatrends. The transitional arrangements – to help workers and firms adjust to these changes – have not been designed as yet, but are highly likely to have implications for the wider tax-transfer system.

66 The issues above are already affecting the tax system to some extent, and may well become more prominent over time. The speed and magnitude of such changes are difficult to predict. The key challenge for the tax system is to have sufficient flexibility to respond to relative shifts in income share, changes in employment relationships and the likely globalisation of the workforce (particularly for high income earners), so as to maintain the government's revenue base over time.

67 The impact of the tax system on the labour market should be thought about alongside other regulatory changes. Both create different types of incentives and it will be important to ensure that those incentives pull in the same direction. For example, any consideration of inequality should consider the tax system's role in redistribution, as well as the non-tax regulatory system's role in influencing pre-distribution outcomes.

68 From a labour market perspective, one possibility is to use the tax system to incentivise firm-based training (as is being implemented for encouraging research and development), given the importance of life-learning in enabling workers to adjust to changing demand for skills as the New Zealand economy adjusts.

A perspective on research, science and innovation

69 Innovation is the introduction of a new, or significantly improved, product, process or technique; in essence, doing something different. It is only by doing things differently that New Zealand will generate higher wages, higher productivity, lower environmental impact, and resilience to future challenges. The process of innovation is therefore a vital component of the New Zealand economy.

70 Research and science are structured processes that generate new knowledge. New knowledge is a critical input into some of the most valuable innovation.

71 New Zealand's research and development intensity – that is, the share of our collective national resources devoted to producing new knowledge – is very low by international standards. Total investment in research and development is equal to 1.28 per cent of GDP, compared with an OECD average of 2.38 per cent. Business expenditure on research and development has been steadily rising, but at 0.64 per cent of GDP it is low – too low – when compared to other small advanced economies, and is well below the OECD average of 1.65 per cent.

72 New Zealand firms do not tend to be as innovative as their counterparts overseas – they are less likely to adopt new-to-market product or process innovation than the OECD average[3] and patent rates in New Zealand are lower (14 per million people) compared with the OECD (40 per million people)[4]. This is a big problem for the future of New Zealand. The tax system may have some part to play in changing that picture.

73 The international context for innovation and research and development is that governments will often actively incentivise these activities, and sometimes through the tax system (the alternative to the tax system is grants). The incentives generally apply to individual firms, and increasingly to certain types of capital investment, in particular seed or venture capital invested in innovative businesses. MBIE can prepare a more in-depth briefing on the international landscape of innovation tax incentives if the Tax Working Group is interested.

74 The Tax Working Group will be aware that the Government is already in the process of implementing a research and development tax incentive. This issue is not discussed in more detail in this submission, but MBIE can engage further with the Tax Working Group if needed.

75 In the further context of the Tax Working Group's assessment of potential changes to the tax system, the following things matter specifically for innovation and research and development:

a. **The tax system is best at subsidising a large number of firms to perform a clearly defined activity (eg research and development)**. Doing so through the tax system brings certain advantages, principally certainty of subsidy for firms through

[3] OECD. (2017). OECD Science, Technology, and Industry Scoreboard 2017: The Digital Transformation. Paris: OECD Publishing. Pages 98-99 and 154-155.
[4] 'Triadic' patent families registered at EU, Japan and US offices, 2013. Taken from: MBIE. (2016). New Zealand Science & Innovation System Performance Snapshot 2016. Page 4.

rules-based self-assessment, which improves the incentive effect of the subsidy. When the activity is less able to be clearly defined, or there are ambiguities about exactly what type of the activity to incentivise (eg 'innovation', 'digital technology'), the tax system will be less effective, and government support may be delivered more effectively through other means.

b. Innovation and research and development are **high-risk activities**. Embedded in both processes is the very real possibility of failure and financial loss. Both capital and firms engaged in these processes expect a higher-risk, higher-return profile than many other business activities. While New Zealand collectively shares in the benefits of success from innovation through the tax system, the losses from failures within firms or investments accrue more unevenly. Encouraging more innovative activity within firms may mean government sharing a portion of the risks, as well as the benefits. The existing research and development tax loss cash-out and forthcoming research and development tax incentive address some of those asymmetries, but much less so for capital investment than for firms.

c. Patient capital with a high risk appetite, in particular seed and venture capital, is essential for growing innovation. Increasing innovation in the New Zealand economy can come from two sources – increasing innovation in existing firms, and encouraging new, more innovative firms. While existing firms have a vital part to play in increasing innovation, international evidence increasingly suggests that much transformative economic activity, including high-value job creation, comes from new high-growth firms.[5] These firms are also more productive than average.[6] These firms rely on seed and venture capital for growth. At a minimum, the tax system should not distort against seed and venture capital as an investment choice. The Tax Working Group could also consider whether an incentive for this type of investment could be desirable (such incentives exist in other countries), but this consideration should be subject first to the principle set out in point a, above.

[5] Haltiwanger, J., Jarmin, R. S. & Miranda J. (2013). Who Creates Jobs? Small versus Large versus Young. *The Review of Economics and Statistics*, MIT Press, vol. 95(2), pages 347-361.
[6] Devine, H., Doan, T., Iyer, K., Mok, P., & Stevens, P. (2012). Decomposition of New Zealand firm productivity, 2001-2008. The Treasury and the Ministry of Economic Development.

A consumer perspective

76 MBIE has a high-level goal of promoting the long-term interests of consumers and considers this perspective when advising on policy changes. Successfully promoting consumers' long-term interests means that:

a. Consumers can access and understand the information they need in order to transact with confidence.

b. Consumers are protected from high levels of detriment.

c. Consumers have access to redress if things go wrong.

d. Consumers benefit from competitive prices, high quality, and innovation in goods and services.

77 The overarching consumer policy consideration for the tax and transfer system is the impact it has on consumer welfare. The Tax Working Group should continue this focus by thoroughly assessing whether any reductions in consumer welfare that may result from a tax are outweighed by the improvements to consumer welfare.

78 Within this context the Tax Working Group should consider the following issues.

The influence of taxes on competition and therefore consumer welfare

79 Given the increase in cross-border purchases, ensuring that there is a level playing-field regarding tax between international and domestic firms can assist in creating a more efficient and competitive marketplace. A more competitive marketplace will benefit consumer welfare.

80 In relation to competition, when considering any potential exclusions from GST, where the line is drawn will be an important decision with the potential to impact on competitive neutrality. For example, removing GST from fresh vegetables, but leaving it on frozen vegetables, could benefit producers who sell fresh vegetables, but harm those who sell frozen vegetables. There is also a loss of simplicity in the tax system.

81 Excluding GST from goods and services that make up a significant proportion of vulnerable consumers' budgets may be an effective mechanism to make this tax more progressive. However the basket of those goods and services would need careful consideration. Excluding GST from fresh fruit and vegetables but not from canned or frozen versions, for example, may favour higher income households. Furthermore, any reduction in competitive intensity could ultimately harm consumers.

82 The Tax Working Group should also consider the extent of the pass-through that would result from any GST exclusions. Pass-through of tax increases or decreases may differ depending on sensitivity of demand to price changes.

Complementary policies may be needed to ensure consumer welfare outcomes

83 Attention needs to be paid to the consumer welfare outcomes any exclusion may be trying to achieve. Excluding some goods and services from GST is not going to result in a universal decrease in price of 15 per cent for those goods and services. Therefore further wrap-around policies may be needed to ensure the targeted consumer welfare outcomes are met without unintended consequences.

The complex drivers of, and impacts on, consumers of taxes to influence behaviour change

84 When considering whether or not to impose taxes intended to influence behaviour change, the Tax Working Group should consider:

- the likelihood of consumer harm if such behaviours are not incentivised (or dis-incentivised, as the case may be) – for example, taxes on alcohol are imposed to try to dis-incentivise the consumption of alcohol due to the consumer harm it can cause
- the extent of cognitive biases that may be driving consumers to undertake certain behaviour – for example, a tax reduction on savings interest may not address any time-inconsistent savings biases that consumers may have
- the extent to which the issue is particularly affecting vulnerable groups – for example, a tobacco excise may be regressive to the extent it falls more heavily on lower income households
- firms' capacity to, and likelihood they will, pass on costs and savings to consumers – for example, if demand is highly inelastic firms are likely to pass tax-related price changes on to consumers.

The transaction costs that consumers may incur

85 Any benefits gained from changes to the current system need to be assessed against any administration or transaction costs that consumers may incur. In particular, if any specific taxes are imposed, consumers need to be provided information to assess and understand these taxes and how they may affect their consumption decisions, so that they may transact with confidence.