LTIB Topics
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Submission on Inland Revenue's Long-Term Insights Briefing

Dear LTIB team

Thank you for the opportunity to comment on the proposed scope of Inland Revenue's long term insights briefing (LTIB). We are available to discuss our comments below if that is helpful.

Key question to consider: *Is tax and its impact on investment and productivity a worthwhile subject to investigate further through an LTIB?*

We believe that tax and the impact on investment and productivity is a worthwhile subject to investigate further through an LTIB.

Key question to consider: *Are there other global tax trends that are critical to this study which should be considered?*

We believe that there are other global tax trends that are critical to this study that should be considered. One global trend is the increasing role that environmental taxes play in other OECD nations. A long-term study of the impact of taxation on investment and productivity should consider the increasing use in the OECD of environmental taxes to change behaviour, raise targeted revenues to offset environmental harm and to raise general revenues to fund Government.

New Zealand makes limited use of environmental taxes compared to most of the OECD, officially around 6% of total tax revenue could be considered environmental taxes.[1] However, these taxes are mainly transport charges and fuel taxes, and they are raised not for environmental purposes but as a revenue source to fund transport and the operation of Government.

The use, design and introduction of environmental taxes is particularly important in terms of the impact of taxation on investment and productivity. It is no longer sufficient to examine investment and productivity solely from a cost of capital perspective.

Key questions to consider: *Are these sensible policy options to consider?*

We agree that the topics set out in the paragraph 36 of the LTIP scoping document are sensible policy options to consider, being:

- reductions in the company tax rate
- measures which increase the present value of capital write offs for capital expenditure
- measures to take account of inflation to reduce overstatements or understatements of capital income

[1] Interim Report of the Tax Working Group, 2018, Chp 9, para 18.

- changes to thin-capitalisation rules which might allow multinational firms to claim greater deductions for interest expense
- changes to allow multinational firms or other firms with foreign shareholders a notional interest deduction on their equity
- specific incentives for particular types of investment or specific types of business, and
- more fundamental changes in the tax base such as the dual income tax structure adopted in Nordic countries with a relatively low flat marginal tax rate on capital income with higher progressive tax rates on labour income.

However, in evaluating the measures above, in addition to other analytical frameworks, we submit that you should consider the following factors:

1. In general, New Zealand's broad base low rate (**BBLR**) philosophy has served us well in the design and maintenance of our tax system and has a broad consensus of support across stakeholders in our tax system. The BBLR philosophy was developed in response to an unbalanced tax system that evolved in the late 1970's and early 1980's where very high tax rates (e.g. 66% top marginal personal rate and 48% company tax rate) were mitigated with dozens of ad hoc incentives and exemptions. This resulted in a narrowly based, high-rate tax system that struggled to deliver efficiency, equity, and adequate revenue. Based on this historical experience, there remains a strong consensus in New Zealand that the BBLR approach is, in practice, more successful than a tax system that has large numbers of incentives or exemptions.
2. On that basis of that history and the BBLR consensus, we propose that the future consideration of tax incentives must be evaluated against a clear framework where there is specific market failure identified (e.g. under investment), the market failure is not driven by other regulatory settings, and a well-designed and administered tax incentive is considered the best policy tool to address the issue when compared to other possible policy interventions.
3. We do not see strong anecdotal evidence that New Zealand tax rates are reducing the interest of foreign direct investors (**FDI**) in New Zealand (although see our later point on coherence of the tax system). In our experience it is other regulatory settings such as Overseas Investment Office criteria that can have a more significant impact on FDI.
4. We note the Tax Working Group's view that New Zealand's imputation credit regime means that the company tax rate for domestic investors is largely a withholding tax while it acts as a final tax on non-resident investors, and therefore the case for a significant reduction in support of additional investment has a relatively high bar to cross. Notwithstanding that, our company tax rate needs to remain competitive with Australia.
5. The key tax distortion in New Zealand that remains is that certain types of economic income that arise in the form of capital gains are, in certain circumstances, not taxed leading to the loss of economic efficiency and a lack of horizontal and vertical equity that puts pressure on the social capital that underpins our successful tax system.
6. Looking further forward into the future it is valuable to test more fundamental tax base changes and evaluate their suitability for New Zealand. But in doing so, the risks and costs of transition from the current system need to be carefully evaluated against the potential benefits of a new system.

Key questions to consider: *Are there other reforms which should also be considered?*

A key principle in a balanced and effective tax system that does not discourage investment and supports productivity growth is coherence. In our view, the relative coherence of the current New Zealand tax system risks being undermined by recent tax policy developments in two key areas as set out below. A key reform to consider is to focus on keeping the tax system coherent. This is not easy work and the threats to coherence are often not obvious and compound over time. But in our view, it is vital for a tax system that does not wish to discourage investment and productivity.

i) **Turning policy into law.**

New Zealand's participation in and contribution to international tax reform such as the Base Erosion & Profit Shifting project (**BEPS**) led by the OECD and the current OECD/G20 Inclusive Framework two pillar solution to address the tax challenges arising from the digitalisation of the economy is positive, highly regarded, and valuable for New Zealand. However, in supporting those global initiatives and operationalising the policy into our own domestic legislation, we believe that we over complicate the policy design and resulting legislation which, from a New Zealand perspective, applies to a relatively small number of taxpayers.

If this trend continues, we will see more and more highly prescriptive and detailed legislation that is drafted in a style that makes it very difficult to discern the policy intent, hard to follow, and increases the risk of drafting errors, is very difficult for all but small number of deeply experienced officials to administer and therefore risks undermining the coherence of the tax system.

ii) **Compounding impacts of different policy choices**

New Zealand's relatively coherent tax system continues to experience policy pressure due to a lack of political consensus to support a comprehensive capital gains tax. As a result, this drives second or third best policy solutions such as the extended Brightline test and the removal of interest deductibility for residential rentals. These policy tools are deployed to address specific and worthwhile objectives in terms of moderating housing cost growth and encouraging new supply. But because they are not well founded in tax policy design, they interact with other existing settings in unexpected ways and damage coherence, leading to a lowering of investment and productivity.

[Commercially sensitive: to be withheld under section 9(2) of the Official Information Act 1982]

s 9(2)(b)(ii)

While there are several pre-existing boundary issues between commercial and residential raised by this example, further issues were introduced by the extension and amendment of the Brightline test and the denial of interest deductibility.

The upshot of this lack of coherence is that the foreign capital and expertise that could have been deployed to expand our dwelling stock has been diverted to other jurisdictions.

Please do not hesitate to contact us if you would like to discuss our submission.

Yours sincerely

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