Our tax system: Bases and regimes

Consultation on the scope of Inland Revenue's long-term insights briefing

Inland Revenue
Te Tari Taake

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Our tax system: Bases and regimes – consultation on the scope of Inland Revenue's long-term insights briefing.

The document is available at
https://www.taxpolicy.ird.govt.nz/consultation/2024/2024-long-term-insights-briefing

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INTRODUCTION

Long-term insights briefings

1. Inland Revenue, together with the Treasury, is responsible for providing advice to the Ministers of Finance and Revenue on the tax and social policies administered through the tax system. Given this responsibility, Inland Revenue has a stewardship role to ensure that it is well placed to advise present and future governments on tax and social policy concerns that are likely to be of interest to New Zealand in the future.

2. As part of carrying out its stewardship role, Inland Revenue, like other government departments, is required to produce a long-term insights briefing (LTIB) once every three years. LTIBs are intended to help us collectively as a country think about and plan for the future. They do this by identifying and exploring long-term issues that matter for our future wellbeing. Specifically, LTIBs are required to make publicly available:

    - information about medium- and long-term trends, risks and opportunities that affect or may affect New Zealand society, and

    - information and impartial analysis, including policy options for responding to the trends, risks and opportunities that have been identified.

3. Departments are required to undertake two rounds of public consultation in producing a LTIB. The first is on the LTIB's topic. The second is on a draft of the LTIB. The topic of Inland Revenue's first LTIB was "*Tax, foreign investment and productivity*" (Inland Revenue, 2022).

4. We are now consulting on the topic of our second LTIB. We are proposing that the LTIB explores what broad structure of the tax system would be suitable for the future. We would approach this topic by looking at our tax system through the lenses of tax bases and regimes. The topic name would be "Our tax system: Bases and regimes".

5. We have developed the scope of this topic after undertaking an environmental scan of our current tax system, how it compares to the tax systems of other countries in the Organisation for Economic Co-operation and Development (OECD) and the issues that are likely to affect our tax system in the future. The environmental scan is set out in chapters 1 and 2 of this consultation document. Chapter 3 then discusses the scope of our proposed LTIB topic.

Environmental scan summary

6. The environmental scan notes that, in common with other OECD countries, New Zealand's tax system has two main bases: income and consumption. Within these bases, New Zealand has for many years followed a broad-based low-rate approach to taxation. This means that taxes are applied broadly with few exceptions, which allows a given amount of revenue to be raised at low tax rates. This approach has contributed to relatively stable tax settings over the last 40 years.

7. The environmental scan provides further detail on how New Zealand's tax system compares to systems in other OECD countries. The level of tax revenue New Zealand raises, relative to the size of the economy, is close to the OECD average. In terms of the composition of tax revenue, New Zealand is unusual in the OECD in not having significant specific taxes on labour income, such as social security contributions or payroll taxes. Further, many OECD countries operate schedular taxation systems that tax capital income at lower rates than labour income. Consequently, most OECD countries have a higher tax burden on employee labour income than New Zealand.

New Zealand raises more than the OECD average in general consumption taxes, relative to GDP, through the goods and services tax (GST). However, New Zealand also raises less than the OECD average in specific consumption taxes, with the overall level of consumption taxation only slightly above the OECD average. In contrast, New Zealand has a higher company tax rate than the OECD average, and high effective marginal tax rates on inbound investments compared to other OECD countries. New Zealand also raises more than the OECD average from recurrent property taxes (through local government rates).

8. The environmental scan notes that New Zealand's tax system has been subject to several major reviews in recent decades. These reviews have noted the benefits of New Zealand's broad-based low-rate approach, in particular that it enables revenue to be raised at relatively low rates and according to a coherent framework. However, the reviews have also identified tensions in the current tax system, including around the comprehensiveness of our income tax bases, the interface of personal and entity tax regimes, and the best mix of tax bases for economic growth. Inland Revenue's previous LTIB also noted that New Zealand's high taxes on inbound investments have the potential to reduce New Zealand's capital stock and labour productivity.

9. The environmental scan goes on to identify several long-term trends that could have significant implications for the future of New Zealand's tax system. The main trends of relevance are increased government expenditure on superannuation if current legislative settings stay in place and pressure on healthcare costs from New Zealand's ageing population. Climate change also presents risks to New Zealand's fiscal position. Future governments will have the option to respond to these pressures by either changing legislative settings, managing expenditure growth, making greater use of user-pays mechanisms or increasing the amount of tax that is raised relative to GDP.

10. Other trends identified include New Zealand's low levels of productivity compared to OECD countries, as well as changes in technology, the impacts of artificial intelligence and changes in the nature of work. However, we do not plan to consider the latter trends in depth because the impacts on the tax system are uncertain or they are more directly relevant to tax administration, which we do not plan to consider in the LTIB.

Proposed long-term insights briefing topic

11. Based on the findings of the environmental scan, we propose that Inland Revenue's next LTIB explore what broad structure of the tax system would be suitable for the future. There are two key issues that motivate the choice of this topic.

12. The first is how to design the tax system in the face of long-term fiscal pressures. We do not assume that future revenue needs (relative to GDP) will increase. However, fiscal pressures give rise to a risk that revenue may need to be higher in the future to meet future expenditure. We propose that a key concept to motivate the LTIB is to consider how to maintain a stable core structure of the tax system while ensuring the system has flexibility to adapt to changing revenue needs over time. A stable core structure is important for providing certainty to taxpayers to help them make long-term decisions. However, our fiscal system will be more resilient if our tax system has the flexibility to raise different amounts of revenue as needed over time.

13. Flexibility can also be thought of in terms of the government's distributional goals. Future governments will have different views on how to distribute the tax burden over time and will be willing to bear different levels of economic cost to meet those distributional objectives. A flexible tax system is one where changes can easily be made to the distribution of the tax burden while maintaining a stable core structure.

14. It might be thought that any tax system is inherently flexible because governments can change tax rates on existing bases at any time. However, there are significant

constraints on doing this for New Zealand's current two main bases – income tax and GST. We discuss this in paragraph 18 below.

15. A second motivation for our proposed topic is to consider whether there are alternative approaches that may better address the tensions in the current system identified in the environmental scan. In considering these issues there are important trade-offs to be made between revenue integrity, efficiency and equity objectives. This motivation arises whether future revenue needs increase or not.

16. We propose to approach this topic by focusing on two elements of the tax system: the regimes through which we tax income and consumption, and our mix of tax bases.

17. The first question we will consider is what economic factors are taxed under the two main bases of our current tax system. Largely, we expect that taxes on income and consumption will remain the key revenue sources going forth, and so will continue to form the main part of our stable core tax structure. We will look at the arguments for the balance of taxation of income versus consumption, and the overlaps and differences between these bases. This question is relevant whether future revenue needs increase or not.

18. We will then look in depth at our main regimes for taxing income and consumption. One idea we propose is that a flexible tax system would be one under which governments could easily change tax rates to change the level of revenue generated or alter the distribution of the tax burden. As set out in chapter 3, we consider there are constraints on being able to do this currently. In particular:

    - New Zealand's main income tax regimes are the personal income tax, corporate tax, portfolio investment entity and trust regimes. The design of these regimes balances trade-offs between revenue sufficiency, efficiency or productivity and fairness. These trade-offs mean that we do not assume that top personal and entity tax rates under these regimes will necessarily be aligned in the future tax system. In particular, setting the company tax rate too high may restrict foreign investment in a way that lowers the income of New Zealanders. If we maintained or lowered the company tax rate, while increasing personal rates, we would create significant opportunities to shelter income in companies. These issues make our income tax system relatively inflexible as a way of responding to increased revenue needs or calls for a more progressive tax system. Therefore, a key question we propose to consider is how the income tax regimes can be made more flexible to meet different revenue needs, or distributional goals, over time.

    - New Zealand's main consumption tax is its broad-based GST. Because GST is applied at a flat rate to expenditure, raising the rate leads to concerns about the impact on low-income households. This is likely to reduce the flexibility of raising GST to respond to long-term fiscal pressures and is a reason to consider measures that could sit alongside a GST increase and reduce the impact of rate increases on low-income households. To do this, we will look at the literature on progressive consumption taxes, including looking at how other countries have provided low-income offsets to compensate for GST rate rises.

19. We will also look at tax bases other than income and consumption. This is worth understanding because fiscal pressures mean that different possible tax bases are likely to be contemplated over the long term. A key consideration is understanding the relative merits of introducing new tax bases versus raising rates on existing bases to meet potential increased revenue needs. Even if future revenue needs do not increase, an important question is whether our current mix of bases is the best to meet efficiency and fairness objectives – that is, whether we have the right mix of bases for our stable core structure.

20. To understand this, we will consider the differences and overlaps between our current bases and alternative bases including considering the pros and cons of taxes on payroll, land, wealth and inheritances.

21. We intend to focus on taxes that are aimed at raising revenue and not on taxes that are aimed at other objectives, such as corrective taxes like environmental taxes. Corrective taxes raise a range of issues that are different to those raised by revenue raising taxes and are a large topic in themselves. Further, environmental taxes were recently considered in depth by the last Tax Working Group.

22. In line with the purpose of the LTIB, our proposed topic is meant to promote public discussion on policy choices. It does not seek to identify immediate actions or make recommendations, but instead focuses on the pros and cons of alternative approaches.

How to make a submission

23. We are seeking your feedback on the scope of the proposed topic of our next LTIB as outlined in this document. We provide the following questions to guide responses:

    - Does the environmental scan identify the key challenges facing our tax system over the long term?
    - How well positioned is our current tax system to respond to these challenges?
    - Do you agree with the focus on how to maintain a stable core structure of the tax system while ensuring the system has flexibility to adapt to different revenue and distributional objectives over time?
    - Do you agree that understanding the pros and cons of different approaches to income and consumption tax is important for understanding what tax system would be suitable for the future?
    - Do you agree that we should consider what is taxed under our current main two bases, and if there are any bases it makes sense to add to our tax mix?
    - Do you think we should consider both options for a future tax system that may have higher revenue needs and options at current revenue levels?

24. The closing date for submissions is **4 October 2024**. Submissions may be made by:

    - email to policy.webmaster@ird.govt.nz with "LTIB topic" in the subject line, or
    - by post to: LTIB topic, c/ - Chief Economist, Policy | Taukaea
      Inland Revenue | Te Tari Taake
      PO Box 2198
      Wellington 6140

25. Please indicate if we can contact you to discuss the points raised in your submission.

26. Submissions may be published on our website and may be the subject of a request under the Official Information Act 1982. If you consider that any part of your submission should not be released, please clearly indicate this including any withholding grounds under the Official Information Act 1982.

27. There will be a further opportunity to provide feedback when Inland Revenue releases a draft of its second LTIB for public consultation. The LTIB will then be finalised and provided to the House of Representatives in mid- to late-2025.

CHAPTER 1: OVERVIEW OF OUR TAX SYSTEM

Introduction

28. New Zealand's tax system provides the main source of revenue for public services, such as our health and education systems. It is essential to our collective wellbeing. We collect around a third of gross domestic product (GDP) in tax, so how our tax system is structured also has significant economic impacts.

29. New Zealand's tax system has two main tax bases: income and consumption. This is also true of other OECD countries if labour income taxes are considered as an income tax. For these two tax bases, New Zealand has for many years followed a broad-based low-rate approach to taxation – that is, one where taxes are applied broadly with few exceptions which allows a given amount of revenue to be raised at low rates.

30. This chapter of the consultation document describes the key features of New Zealand's tax system and how it compares to other OECD countries' systems. It also provides, in box 2, a summary of key issues raised in past reviews of New Zealand's tax system. Chapter 2 discusses trends that are relevant to the tax system over the long term.

New Zealand's tax system

Tax as a proportion of the economy

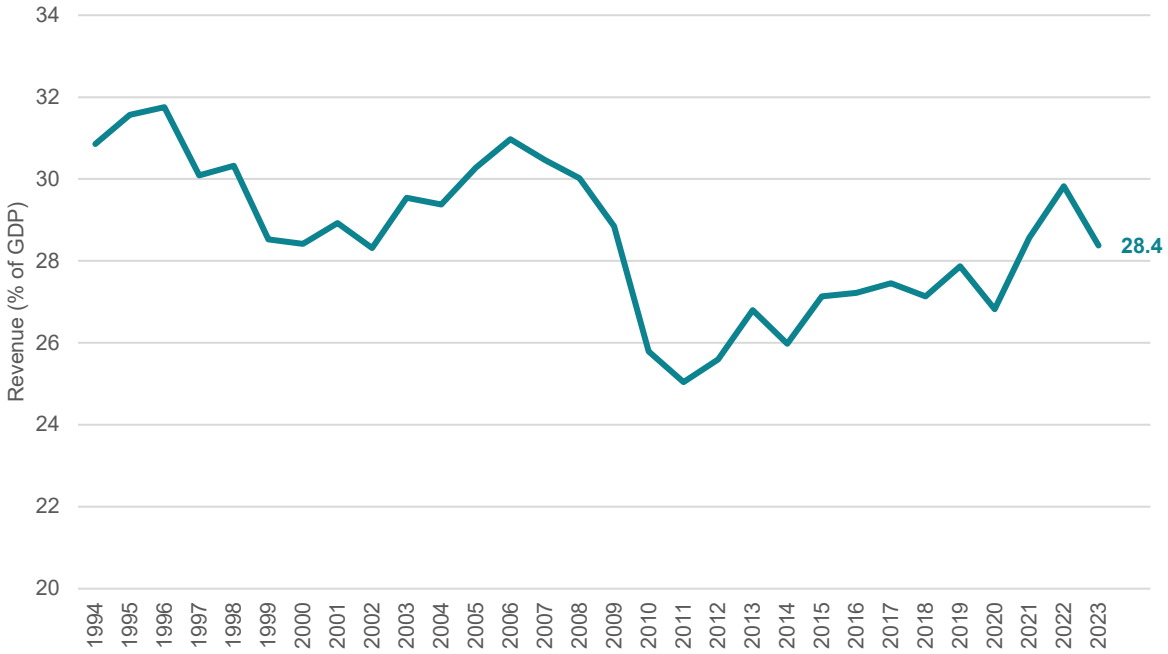
31. In New Zealand, taxes are mainly levied at the central government level. Local government levies "rates" based on property values to fund certain local expenditures. Central and local government together are known as "general government". Graphs in this section on New Zealand's tax system are for central government. They present consolidated core Crown tax revenue from the 1993–94 June year.[1] Prior to this, they present total Crown receipts.[2]

32. In the year ended June 2023, consolidated core Crown tax revenue as a proportion of GDP was 28.4%. Tax revenue is the main source of central government revenue, constituting 91% of core Crown revenue in the year ended June 2023.

33. The amount of tax collected as a proportion of GDP has varied over time due to both policy changes and economic factors, such as changes in GDP. Figure 1 shows that core Crown tax revenue as a proportion of GDP has varied around 7 percentage points over the last 30 years, varying between 25% and 31.8%.

[1] Consolidated tax revenue excludes tax paid by government entities within the accounting unit. The core Crown is an accounting unit of central government. Crown entities and State-Owned Enterprises are not part of core Crown. Core Crown has been a concept used since the 1993–94 year; prior to that total Crown is used.
[2] Prior to the 1993–94 year, the official tax series was only based on tax receipts (that is, a cash measure). A revenue-based measure was adopted from the 1993–94 year. Years in the graphs refer to the June year end.

Figure 1: Core Crown tax revenue as a percent of GDP, 1994–2023



Source: The Treasury, Fiscal Time Series Historical Indicators, 2024

New Zealand's tax bases

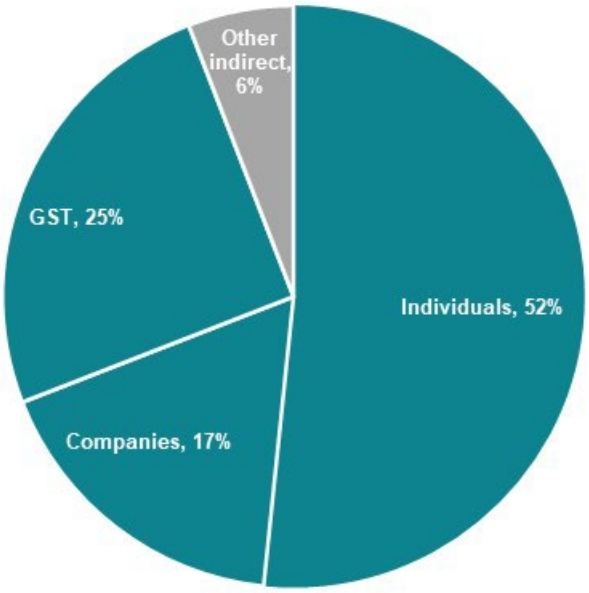
34. Figure 2 shows that over 90% of core Crown tax revenue is sourced from the two main bases of income tax (from individuals and companies) and GST. On a consolidated basis, direct taxes on individuals[3] provide about twice as much revenue as GST.

35. Other indirect taxes, such as excise taxes and duties, constitute around 6% of core Crown tax revenue. New Zealand does not have inheritance or estate taxes, or land tax at the central government level.

36. At the general government level, local government rates are around 5.5% of general government tax revenue, or 1.9% of GDP.

[3] Tax on individuals includes personal income tax and some other taxes such as taxes paid by trusts, Māori authorities and partnerships, fringe benefit tax (except for 1989–90) and resident withholding tax. It is adjusted for donations tax credits and the independent earner tax credit and rebates.

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



Source: The Treasury, Tax Outturn Data, 2024

37. Figure 3 shows the change in the central government tax mix (as a proportion of GDP) since the 1980s when New Zealand's tax system was significantly reformed. It shows that income tax from individuals, relative to GDP, declined in the 1980s and 1990s following reforms. Income tax from individuals declined again following personal tax rate decreases in 2010 but increased after that due to a combination of nominal wage growth and the increase in the top personal tax rate to 39% from April 2021.

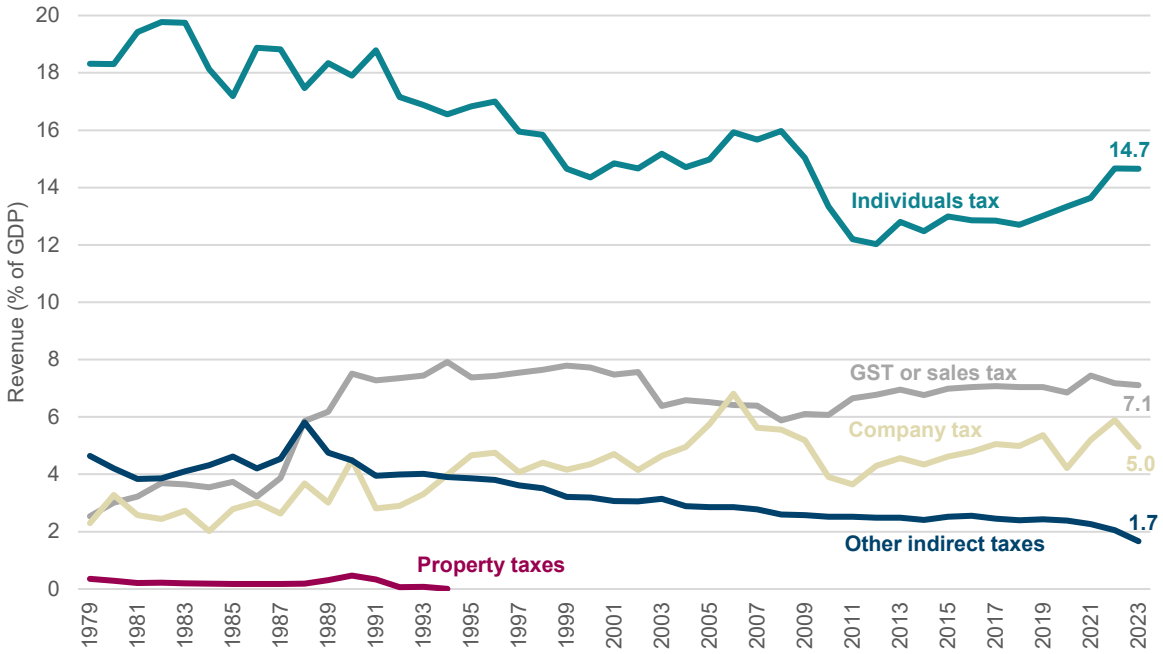
38. Figure 3 also shows the effects of the introduction of GST in place of sales tax on 1 October 1986, initially at a rate of 10% but raised to 12.5% in 1989 and 15% in 2010. As a proportion of GDP, sales tax or GST has increased from around 3% of GDP in the early 1980s to around 7% now.

39. Company, or corporate, taxes are a relatively volatile revenue source.[4] As a percent of GDP, company taxes are around double what they were in the 1980s.

40. A central government land tax was in place until the 1990s but did not raise much revenue in this period. There was an estate duty until the 1990s[5]; this however raised very little revenue by the 1980s and 1990s. In figure 3, the property taxes line consolidates central government land tax and estate and gift duty.

[4] Company tax in these calculations includes net tax on companies, portfolio investment entities, unit trusts, superannuation funds, clubs and societies, and Crown entities, as well as qualifying company election tax, non-resident withholding tax, dividend withholding tax and foreign dividend withholding payments.
[5] Gift duty was in place until 2011.

Figure 3: Sources of central government tax revenue as a percent of GDP, 1979–2023[6]



Source: Stats NZ & The Treasury, 2024[7]

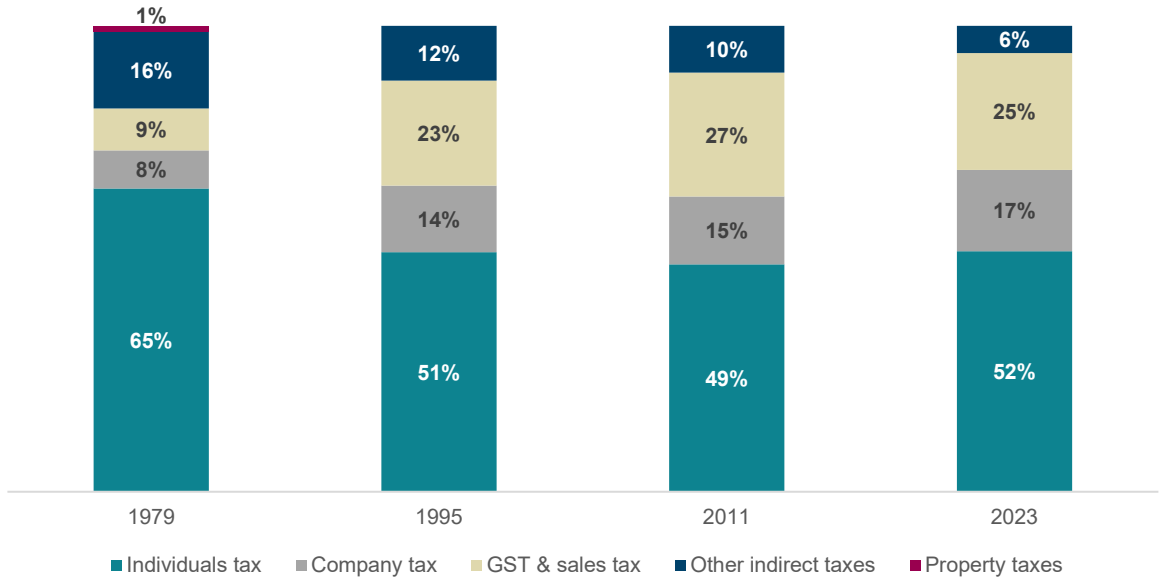
41. The reforms in the 1980s were aimed at broadening the income and consumption tax bases to reduce the economic distortions created by the tax system, reduce compliance and administrative costs and improve the ability of the government to meet its revenue requirements.

42. Prior to these reforms, New Zealand's tax system relied heavily on the personal income tax system. Figure 4 shows that in 1979 income tax on individuals constituted 65.1% of central government revenue, as opposed to 51.4% in 1995, 48.8% in 2011 and 51.6% in 2023. The sales tax in place prior to the introduction of GST had many exemptions and a number of rates applying to different goods. With its narrow base and the exclusion of services, which represented a growing part of the economy, the sales tax was not capable of generating significant revenue.

43. The introduction of GST significantly broadened the consumption tax base and resulted in a significant increase in the share of tax revenue from general consumption taxes from 9.0% of central government tax revenue in 1979 to 22.5% in 1995 and 25.0% in 2023 (on a consolidated basis).

[6] Data in figures 3 and 4 are total Crown tax receipts until year ended June 1993 and then core Crown consolidated tax revenue.
[7] Data for figures 3 and 4 are taken from Stats NZ's official yearbook for the years 1979–1990 and the Treasury's tax outturn data for the years 1991–2023.

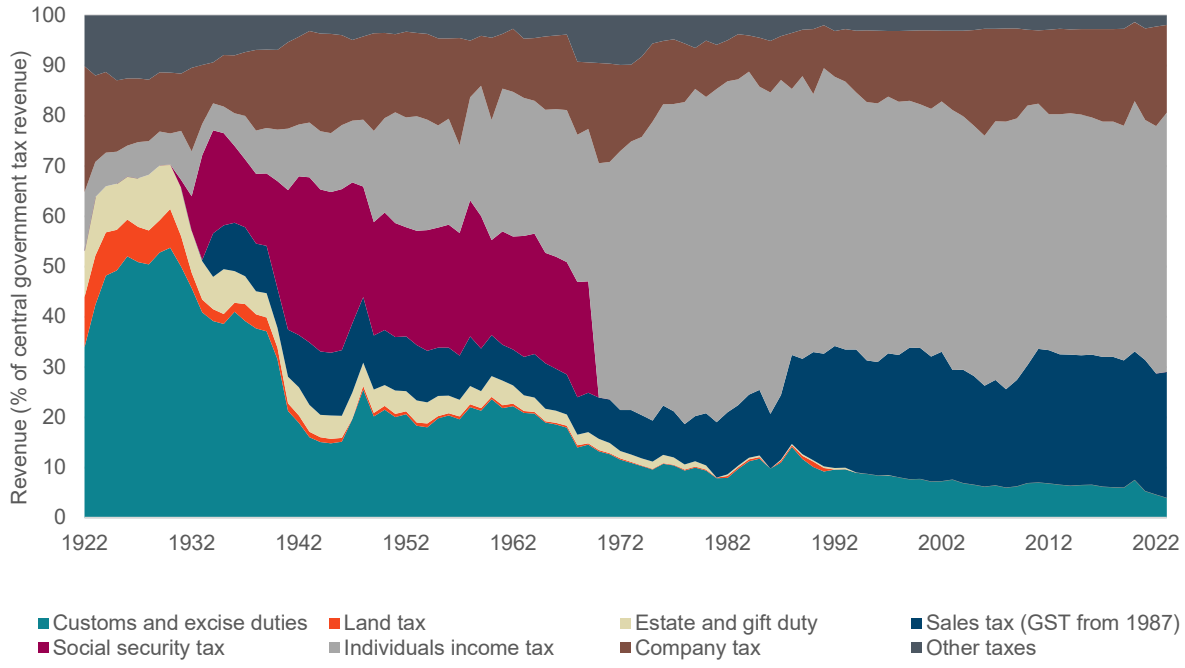
Figure 4: Sources of revenue as a percent of central government tax revenue



Source: Stats NZ & The Treasury, 2024

44. From a longer-term perspective, New Zealand has had different bases and different mixes of bases over time. In the early part of the 20th century customs and excise duties were an important source of revenue (being 74% of central government revenue in 1903). Up until the 1990s New Zealand had a central government land tax and estate duty. New Zealand also had a social security tax between 1930 and 1969. Figure 5 shows the share of central government revenue from different tax bases from 1922 to 2022 and box 1 provides more detail on New Zealand's historical tax bases.

Figure 5: Sources of revenue as a percent of central government tax revenue



Source: Stats NZ & The Treasury, 2024[8]

[8] Data for figure 5 is taken from Stats NZ's official yearbook for the years 1922–1990 and the Treasury's tax outturn data for the years 1991–2023.

Box 1: Historical changes in the composition of New Zealand's tax base

Customs and excise duties

Duties on alcohol, tobacco, tea, sugar, grains and other products were easy to collect in the early 1900s and were a main source of government revenue until the First World War. The fairness of these taxes was often contested and over time they were scaled back and replaced by more progressive and broad-based forms of taxation.

Land tax

A central government land tax was first introduced in 1891. There was initially both an "ordinary" and a "graduated" land tax: the graduated land tax was imposed at progressively higher rates depending on the value of the estate. It was seen as both an economic tool to incentivise land development, and a social tool to help break up large estates and prevent the "landlordism" seen in Britain at the time. (Absentee landlords paid a further surcharge.) It was an important revenue source for many years.

Difficult economic conditions in the 1930s and 1940s saw revenue drop as land values fell. Affordability problems arose because the tax was not based on cash flows. Exemptions and concessions accumulated, and obtaining accurate and timely valuations represented an ongoing challenge. Eventually the land tax came to be perceived as "discriminatory, illogical and unequal" (New Zealand Parliamentary Debates, 1967). Through the 1950s and 1960s the tax was gradually rolled back until eventually it was applied only to commercial property. Governments were unwilling to forgo the revenue entirely however and an overhaul was attempted in 1989. This failed to fix the fundamental problems and political opposition continued to grow. Abolition was announced in 1990.

Estate and gift duties

Estate duties were first introduced in 1866, and gift duties followed shortly afterward to prevent people avoiding estate duties. Revenue from estate duties was slightly above 10% of the central government tax take at their peak. In 1949 the government began slowly narrowing the scope of the tax. Estate planning became more sophisticated, and anti-avoidance measures did not keep up (Littlewood, 2012). Revenue dwindled to negligible levels. Estate duties were eventually abolished in 1993. Gift duty was retained for a time to support social assistance targeting but was eventually retired with effect from October 2011.

Social security tax

The first social security tax was the unemployment levy enacted in 1930 to help pay for the costs of unemployment relief during the Depression. This was initially implemented as a fixed annual charge (a poll tax) on men of working age, but in 1931 the annual charge was lowered and supplemented by a 5% flat tax levied on wages and other income. The levy stayed in place through the 1930s. In 1940 there was an expansion of social security benefits (now including superannuation), and the levy was renamed the social security tax. A temporary increase in the tax during World War Two paved the way for a further expansion of benefits, with the levy settling at 7.5% in 1947.

Income from the levy contributed to the current costs of social security, with the balance of costs met from the Consolidated Fund. Contributions were not set aside to fund future costs. In the 1960s the Social Security Fund merged with the Consolidated Fund. There was a gradual move away from a flat social security tax to a more progressive levy structure, and in 1969 the social security tax was fully replaced by income tax.

Tax regimes

45. By tax regimes we mean the rules for taxing the bases that are taxed. As noted, our main bases are income and consumption. This section discusses the main regimes applying to income and consumption.

46. Consumption is taxed through GST. GST is a value added tax (VAT) levied on sellers of goods and services. This means that it is applied at each stage of the supply chain and sellers can claim credits for GST on their inputs. In this way, the final consumer pays GST on the final price. Value added taxes differ from sales taxes in that the latter are assessed and paid only at the end of the supply chain.

47. In New Zealand, GST is levied at a flat rate of 15% (on the pre-GST price) and is applied to most goods and services. There are some expenditure types that do not have GST directly applied to them including rent, airfares for overseas travel and mortgage payments. Given its broad base, New Zealand's GST imposes a tax burden broadly proportional to the expenditure of households of different income levels. In contrast, other countries often exempt goods and services that are considered necessities, such as certain food categories, which can result in a slight degree of progressivity, relative to expenditure, in other countries' VAT systems.[9]

48. New Zealand's income tax is more complicated but can be grouped into four broad income tax regimes: personal, company, portfolio investment entity (PIE) and trusts. Each of the entity regimes (company, PIE and trusts) is designed to be integrated into the personal tax regime to some extent. This is so that as much income as possible is taxed according to the personal tax scale. However, the approach to integration differs in each case and, in each case, there is less than full integration. We describe each of these income tax regimes below.

49. The **personal** tax regime taxes individuals following a progressive income tax scale. Under this tax scale, marginal tax rates increase in steps as income increases. As discussed below, this results in increasing average tax rates across the income distribution (that is, an increasing amount of tax paid relative to income as income increases). The personal tax system is the main way that progressivity is provided in the tax system. Table 1 shows the marginal tax rates and thresholds that applied up to 30 July 2024, and the rates and thresholds applying from 31 July 2024.

Table 1: Income tax scale

Taxable income		**Statutory tax rate**
Up to 30 July 2024	**From 31 July 2024**	
$1–$14,000	$1–$15,600	10.5%
$14,001–$48,000	$15,601–$53,500	17.5%
$48,001–$70,000	$53,501–$78,100	30%
$70,001–$180,000	$78,101–$180,000	33%
Over $180,000	Over $180,000	39%

[9] Thomas (2020) found a small degree of regressivity in the GST-to-expenditure ratio in New Zealand given that exempt categories tend to benefit higher income/expenditure households.

50. Income taxed at personal tax rates includes income from employment (including wages, salary and self-employment income), and income from businesses, such as partnerships, that is attributed directly to individuals. It also includes distributed capital income such as interest, dividends and rent. New Zealand's personal income tax does not distinguish between capital and labour income. As discussed later, some other countries tax these forms of income at different rates or include additional taxes on labour income in the form or payroll taxes or social security contributions.

51. **Companies** are taxed at a rate of 28% on their taxable income. Distributed income (dividends) is subject to tax at the shareholder's individual marginal tax rate under the personal tax system. The imputation system operates to ensure that income that is distributed to shareholders is taxed at personal rates. When income is distributed, an imputation credit is given for the company tax paid on the income. Under the regime, company tax will normally be a final tax for foreign shareholders.[10] Unit trusts are also taxed at the company rate.

52. The rules for taxing Māori authorities use similar principles, with tax being applied to Māori authority taxable income at the rate of 17.5%, which represents the assumed marginal rate for individual members of a Māori authority.[11] As with companies, shareholders are taxed on dividends at their marginal tax rate, with a Māori authority credit (similar to an imputation credit) given for tax paid by the Māori authority.

53. A **portfolio investment entity** (PIE) is an entity that invests the contributions from its investors in different types of passive investment. Companies, trusts and superannuation schemes can become PIEs. PIE income is taxed according to the personal tax rate scale, however the maximum rate that PIE income can be taxed at is 28%. Because a PIE may be a company or a unit trust, the top PIE rate is aligned to the company tax rate.

54. The fourth income tax regime is **trusts**. Trustee income (that is, income taxable to the trust) is taxed at a flat rate. This is 39% for trusts with income over $10,000 and 33% otherwise. The two rates were introduced to ensure that most trustee income is taxed at the top marginal rate while also minimising the risk of over-taxation for trusts with lower rate beneficiaries. Beneficiary income (that is, income vested in or paid to the beneficiary within a year of it being earned by the trust) is generally taxed at the marginal tax rate of the trust's beneficiary.

Progressivity, incidence and fiscal drag

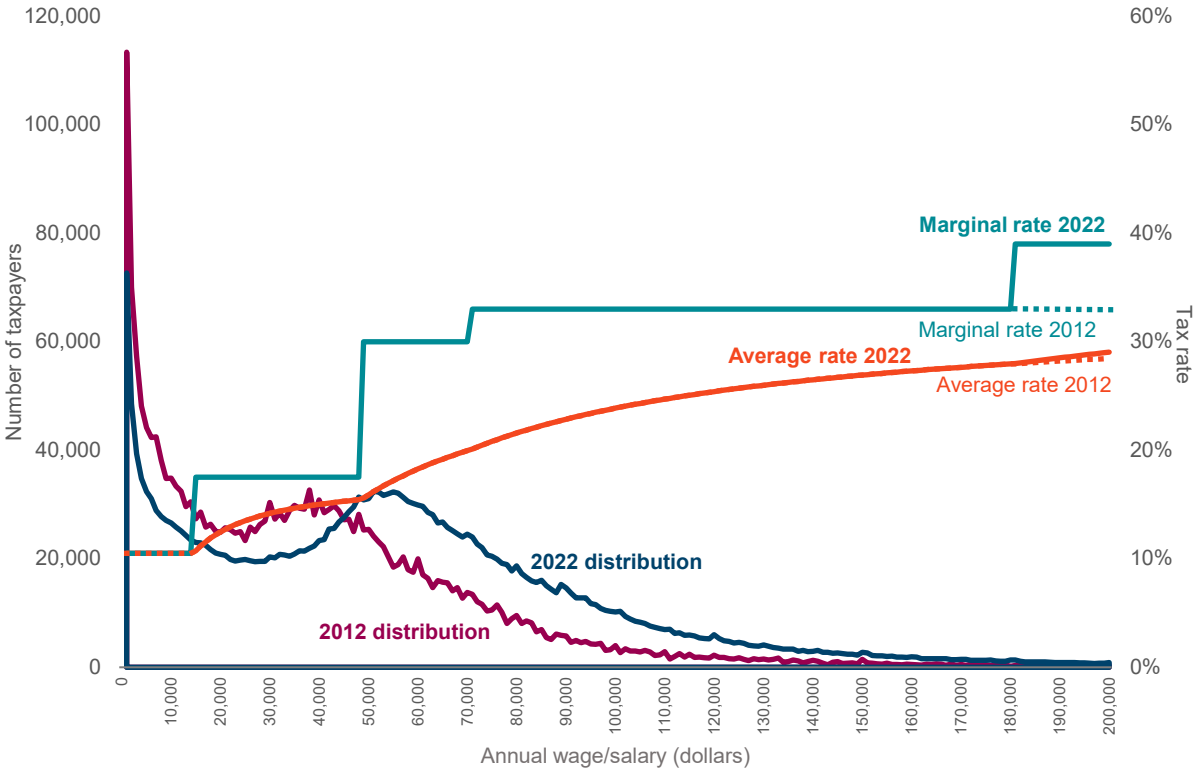
55. As noted above, progressivity is largely provided through the personal tax system (which also taxes distributions from entities) through marginal tax rates for personal income increasing at defined thresholds in the personal tax schedule (see table 1). This results in the average tax rate on individuals' personal income (that is, total tax paid relative to total income) increasing as income increases.

56. Inflation can change the level of progressivity of the tax and transfer system over time in ways that were not intended by the government. In relation to personal tax, when the marginal tax rate thresholds are kept constant over time, while individuals' incomes increase due to inflation or increases in real wages, more income will be taxed at higher marginal tax rates resulting in a higher proportion of income being paid in tax. This is known as fiscal drag.

[10] Depending on the location of the non-resident and their level of shareholding, a distribution of income that was not taxed at the company level may be subject to non-resident withholding tax.
[11] The term "Māori authority" is a tax-specific term. It applies to companies or trustees of a trust that manage communally owned assets whose ownership and administration are subject to certain statutory restrictions or government processes.

57. Figure 6 plots the statutory marginal tax rates in 2012 and 2022 (teal lines) and the resulting statutory average tax rates in 2012 and 2022 – that is, the average tax rate for a given level of income (orange lines). The ruby and blue lines show the distribution of income in 2012 and 2022. Figure 6 shows that between 2012 and 2022, there was a general increase in salary and wages resulting in more people having a higher average tax rate. This is shown by the shift in the distribution of incomes from 2012 to 2022 (ruby to blue line). As a result, the average tax rate for a worker earning the median salary or wages was 14.6% in 2012, which increased to 16.4% in 2022.

Figure 6: Impact of fiscal drag, 2012 and 2022



Source: Inland Revenue calculations

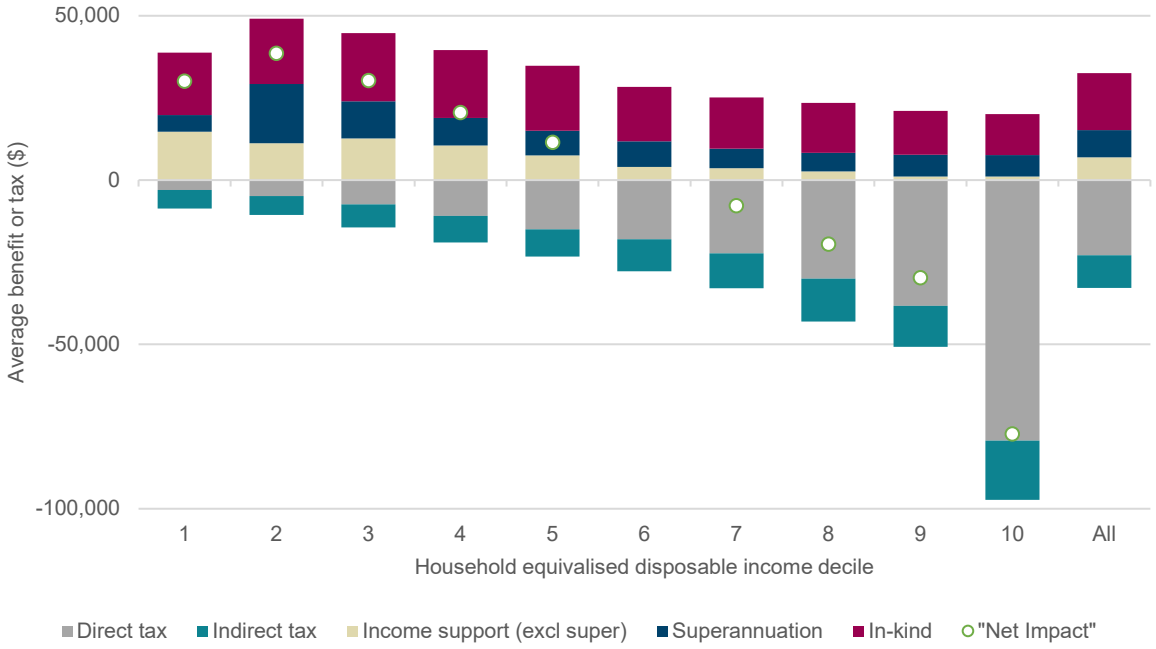
58. Overall, however, it is the total impact of the tax system, the transfer system and government expenditure that determines the total quantity of redistribution from government action (the public finance mix). Fiscal incidence studies seek to measure the combined impact of all these government interactions. Studies in New Zealand have done this by:

- taking households' **market income** (from wages, salaries, self-employment, investments, gifts and inheritances)
- adding income from government transfers (superannuation, working age income support and other transfers/tax credits) to get **gross income**
- subtracting direct income tax (and Accident Compensation Corporation (ACC) levies) on market income and transfers to get **disposable income**
- subtracting indirect taxes on consumption expenditure (GST and excise taxes) and adding in the cash value of in-kind benefits from health and education services (this means around 60%–70% of core Crown expenditure is included). This gives **final income**.

59. The New Zealand Treasury's latest fiscal incidence study is for the year 2018–19 (Nguyen & Wright, 2024). It shows the distribution of the level of direct and indirect taxes (GST and excises), income support and in-kind benefits (from health and education expenditure) across household disposable income deciles (that is, dividing the population into ten income groups and providing the average value for each group). The distribution of the average level of direct taxes is skewed towards higher-income households (grey bars in figure 7). By contrast, the average value of indirect taxes is more evenly distributed across the population, due to GST being levied at a flat rate relative to expenditure (teal bars in figure 7).

60. Average transfers are larger for lower income deciles, with income support (excluding superannuation) being insignificant for deciles nine and ten on average (taupe bars). Average New Zealand Superannuation (including veterans' pensions) payments are highest in the second decile but remain significant at high deciles (blue bars). Deciles one to five show positive values of average net fiscal impact (dots) whereas the highest four deciles show negative values of average net fiscal impact.

Figure 7: Average taxes and government expenditure over household disposable income deciles, 2019



Source: Nguyen & Wright, 2024

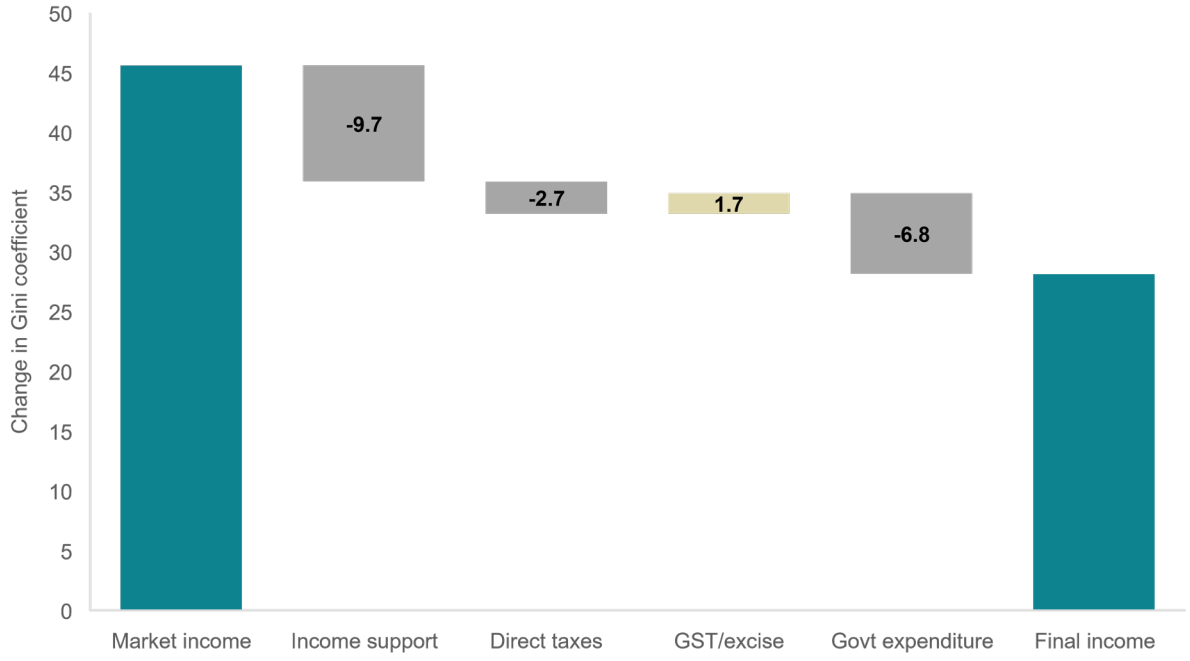
61. The authors calculate the impact of each government intervention on income inequality through measuring the Gini coefficient (scaled by a factor of 100) and how it changes with each government intervention. The Gini ranges from 0 to 100, with values closer to 0 representing higher equality.[12] A caveat is that the Gini is calculated relative to annual income, and so does not take account of savings shifting income and consumption over time periods. Studies calculated over longer periods of time tend to show a more equal distribution of income.

[12] The Treasury fiscal incidence study calculates the Gini based on individual incomes. For each income definition they equivalise the income of each household, assign the equivalised value to each individual in the household, and calculate the Gini coefficient of the resulting distribution of incomes over individuals in the Household Economic Survey sample.

62. In the Treasury's fiscal incidence study, the initial market income Gini is 45.6, as shown in figure 8. Moving to gross income, income support (including superannuation) payments reduce the Gini by 9.7 points. Moving to disposable income, direct taxes reduce the Gini by another 2.7 points. This means the change in Gini from market to disposable income is 12.4 points. Consumption taxes increase the annual income Gini by 1.7 points. This is because consumption taxes are a larger share of the annual income of lower income deciles. Finally, government expenditure on health and education reduces the Gini by 6.8 points. The final income Gini is 28.

63. This illustrates the importance of government expenditure in reducing income inequality with the tax system also playing an important but smaller role. Similar to other OECD countries, transfers are larger than taxes in the reduction of the Gini from market income to disposable income.

Figure 8: Decomposition of changes in Gini coefficient, 2019



Source: Nguyen & Wright, 2024

64. There are several difficulties in comparing Ginis across countries, such as different definitions of income and differences in the age structure of countries. However, OECD data suggests that the reduction in Gini from market to disposable income (that is, taking account of income support and direct taxes) for New Zealand is towards the middle of the spectrum for OECD countries. Countries with higher tax-to-GDP ratios, such as Finland, France and Belgium, show the largest fall in Gini from market to disposable income (being in excess of 20 points). In contrast, countries with a low tax-to-GDP ratio, such as Mexico, Chile and Costa Rica, show the smallest fall in Gini from market to disposable income (being below 10 points). For New Zealand, the fall in Gini from market to disposable income appears to be similar to that of Australia (being in the range of a reduction of 12–13 points over recent years).

Box 2: Reviews of New Zealand's tax system

New Zealand's tax system has been subject to three reviews in the last 25 years. This includes the McLeod Review in 2001, the Victoria University of Wellington (VUW) Review in 2010 and the Tax Working Group (TWG) in 2019. Further, in 2022 Inland Revenue published its first LTIB on *Tax, Productivity and Foreign Investment.* The main issues raised in these reviews are listed below.

Comprehensiveness of income tax: All three reviews discussed gaps in income taxation, particularly income arising from capital gains, as a notable way that the income tax is not comprehensive. As discussed in the next section, New Zealand is unusual in not having a general approach to taxing capital gains – although many capital gains are captured in ordinary income. However, views have been divided on the extent of any problems this causes and the best solution.

Interface of personal and entity regimes: The McLeod and VUW reviews were concerned with the interface between the personal tax system and entity taxation. One principle that our current tax system is arguably built on is that income, no matter how earned, should be taxed as close to the personal marginal tax rate of the individual earning the income as possible. As noted earlier, currently top personal rates are higher than the company and PIE rate, which results in income earned through entities not always being taxed at close to personal tax rates.

The best tax mix for economic growth: Both the McLeod and VUW reviews considered arguments about the appropriate mix of tax bases, particularly the best mix of income versus consumption taxes. The VUW review, for example, argued that income taxes are more harmful to economic growth than consumption taxes. There are long-standing debates in the economics literature as to the best mix of consumption and income taxes.

Impact of tax on the quantity of investment: As New Zealand's investment needs exceed its savings, foreign investment supports growth of the capital stock, which supports productivity and higher wages. Inland Revenue's 2022 LTIB suggests that New Zealand has relatively high costs of capital (the cost of capital is the minimum real pre-tax rate of return for an investment to be profitable after-tax) and effective marginal tax rates on inbound investment compared to other OECD countries (see figure 18). This means that investments that would be profitable in other countries may not be profitable in New Zealand due to the tax cost.

Impact of tax on the quality of investment: The 2022 LTIB also suggested there can be considerable variability in costs of capital of different investment types, particularly at higher inflation rates and to the extent that tax depreciation diverges from economic depreciation. This suggests that New Zealand's tax settings are likely to influence the type of investments undertaken, which may have economic costs if it results in investment not being directed to projects with the highest return.

Taxation of savings: A related issue is the different tax treatment of different forms of savings by domestic residents. Analysis by the TWG suggested that features of the tax system create biases as to where savings are allocated. These features include the PIE regime capping the taxation of income in PIEs at 28%, differences in the taxation of foreign shares compared to domestic shares and the non-taxation of some capital gains. Further, taxation of the inflation component of the return to savings can create biases.

Comparison to other countries' tax systems

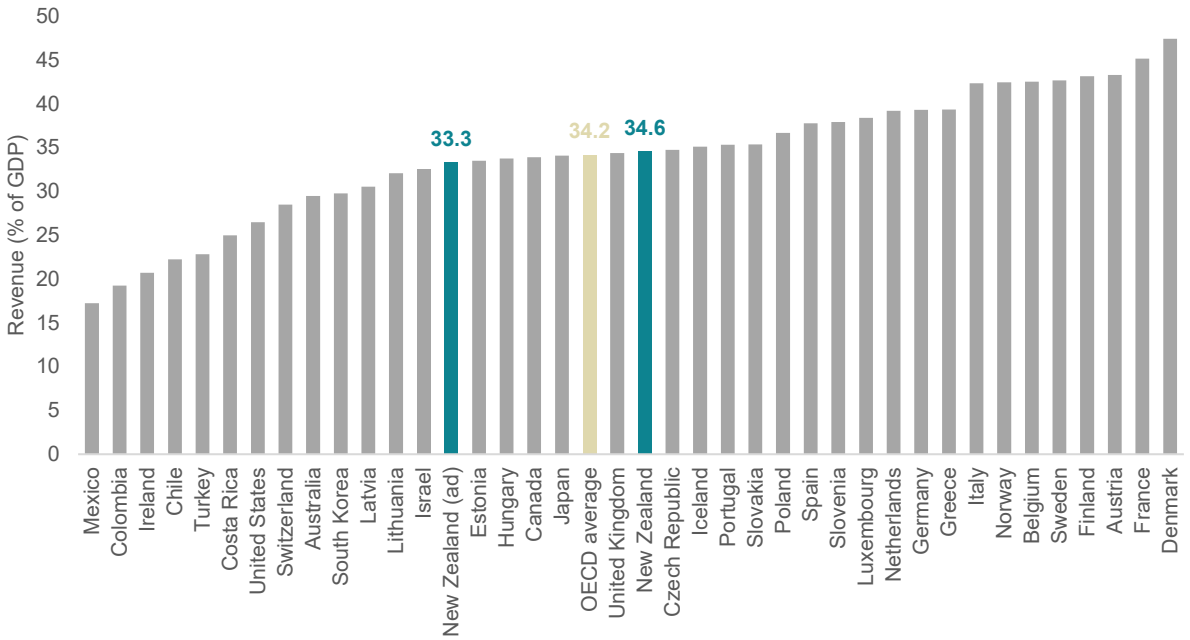
65. This section looks at how New Zealand's tax system compares to the tax systems in other OECD countries. The analysis is generally based on data in the OECD's global revenue statistics database.[13] To enable international comparability, the analysis uses OECD data at the general government level (that is, including both central and local government). This means that data for New Zealand includes local government rates. In this section, "tax revenue" refers to general government tax revenue.

66. Further, the OECD's data is calculated on an unconsolidated basis, meaning that it includes taxes paid by the government. This significantly affects the OECD's data for New Zealand because New Zealand is unusual among OECD countries in charging GST on public services. In addition, New Zealand taxes its sovereign wealth fund (the New Zealand Superannuation Fund (NZSF)), whereas such funds are often untaxed in other countries. Therefore, we have adjusted the OECD's figures for New Zealand to exclude GST on public services, to the extent it is likely to result in an artificially high ratio for New Zealand, and tax paid by the NZSF.[14] These adjusted figures are presented in the charts as "New Zealand (ad)". Years in the graphs refer to the December year end.

Tax as a proportion of the economy

67. New Zealand raises a similar level of tax revenue as a proportion of its economy compared to the OECD average. Figure 9 shows that, in 2021, New Zealand's tax revenue as a proportion of GDP was 34.6% when including all taxes paid by the government and 33.3% when using adjusted figures, compared to the OECD average of 34.2%.

Figure 9: General government tax revenue as a percent of GDP, 2021

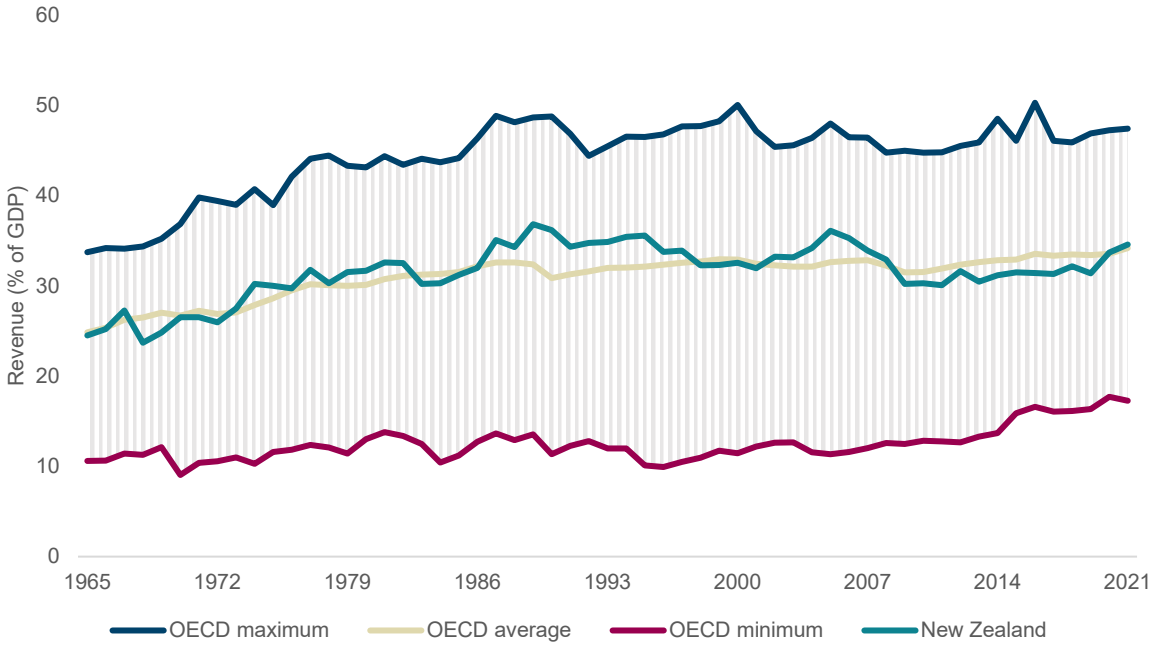


Source: OECD, 2024

[13] Data for figures 9 to 19 and 21 were taken from the OECD's database retrieved from https://stats.oecd.org.
[14] For GST, we have removed GST relating to the salary and wage component of the funding of government departments and Crown entities. This is because in countries that do not apply GST (VAT) to public services, government expenditure on public services will generally include the amount of VAT that applies to third-party supplies to the public entity. Note, the NZSF adjustment is immaterial for 2021 at 0.01% of GDP.

68. Figure 10 shows that New Zealand's level of tax revenue as a proportion of its economy has largely tracked changes in the OECD average over time. The OECD average proportion moved from 24.9% of GDP in 1965 to 34.2% in 2021. Over the same period, New Zealand's proportion moved from 24.5% to 34.6% on an unadjusted basis.

Figure 10: General government tax revenue as a percent of GDP, 1965–2021[15]



Source: OECD, 2024

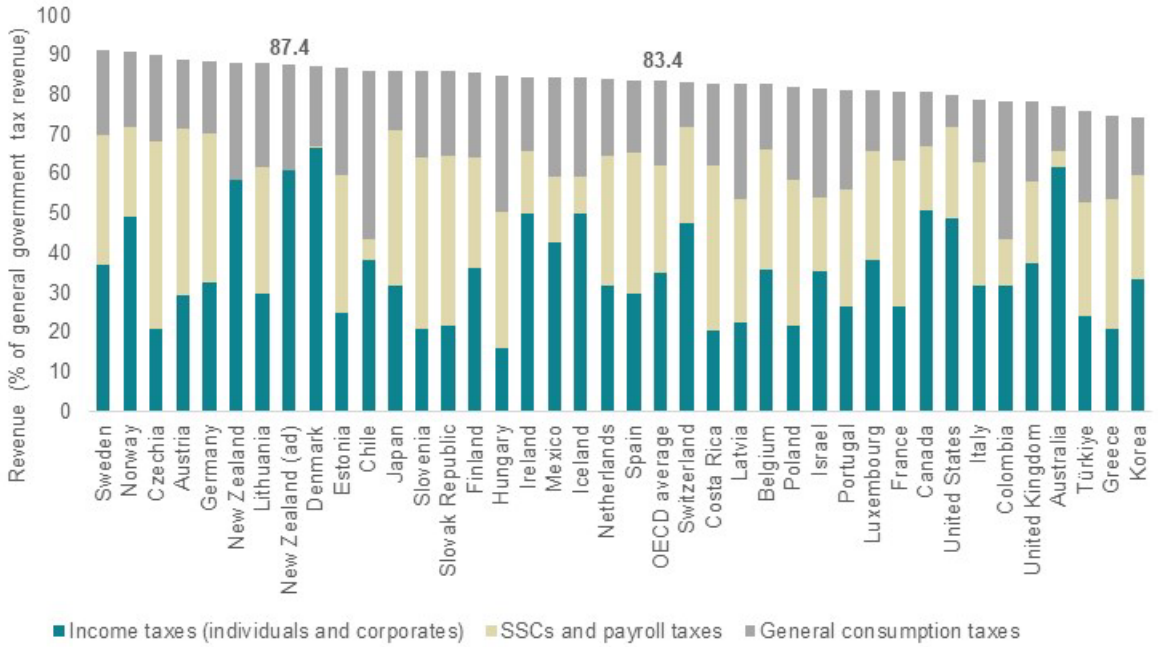
Tax bases in OECD countries

69. New Zealand is similar to other OECD countries in sourcing most of its revenue from total taxes on income and from general consumption taxes. We define total taxes on income to include individual and corporate income taxes[16] (which exist in all OECD countries) as well as social security contributions (SSCs) and payroll taxes (which exist in many other countries, but only in the form of ACC levies in New Zealand[17]). General consumption taxes include value added taxes (like GST in New Zealand) and sales taxes (like those in the United States).

70. Figure 11 shows that, in 2021, the combined revenue from total taxes on income and general consumption taxes ranged from 74.1% to 91.1% of tax revenue across the OECD. New Zealand's proportion was near the top of this range at 87.4% (when adjusted for GST on public services and tax paid by the NZSF), above the OECD average of 83.4%. As noted in paragraph 65, these figures are at the general government level (including local government rates in the denominator).

[15] Figure 10 shows the level of tax-to-GDP for all current OECD members. The maximum and minimum lines show the highest and lowest level of tax-to-GDP in any country each year. The graph is based on data available in the OECD's database, which does not include data for every country in every year.
[16] The OECD's classification of corporate income taxes includes taxes levied on the net income or profits, and the capital gains, of corporate enterprises.
[17] ACC levies meet the OECD's definition of SSCs. ACC levy revenue is only 1% of GDP. ACC levies are not included in the OECD's data for New Zealand to ensure consistency with countries that have compulsory work-related private insurance to cover accidents and occupational diseases.

Figure 11: Sources of revenue as a percent of general government tax revenue, 2021



Source: OECD, 2024

71. Since 1990, revenue from income taxes[18] as a proportion of general government tax revenue has varied between 53.0% and 63.0% in New Zealand, and 32.2% and 36.2% on average across the OECD. Over the same period, the revenue share of general consumption taxes has increased in New Zealand (from 22.4% in 1990 to 29.3% in 2021 when including all GST on public services) and on average across the OECD (from 18.5% in 1990 to 21.4% in 2021), while the revenue share of specific consumption taxes, such as excises, has declined in New Zealand and on average across the OECD.

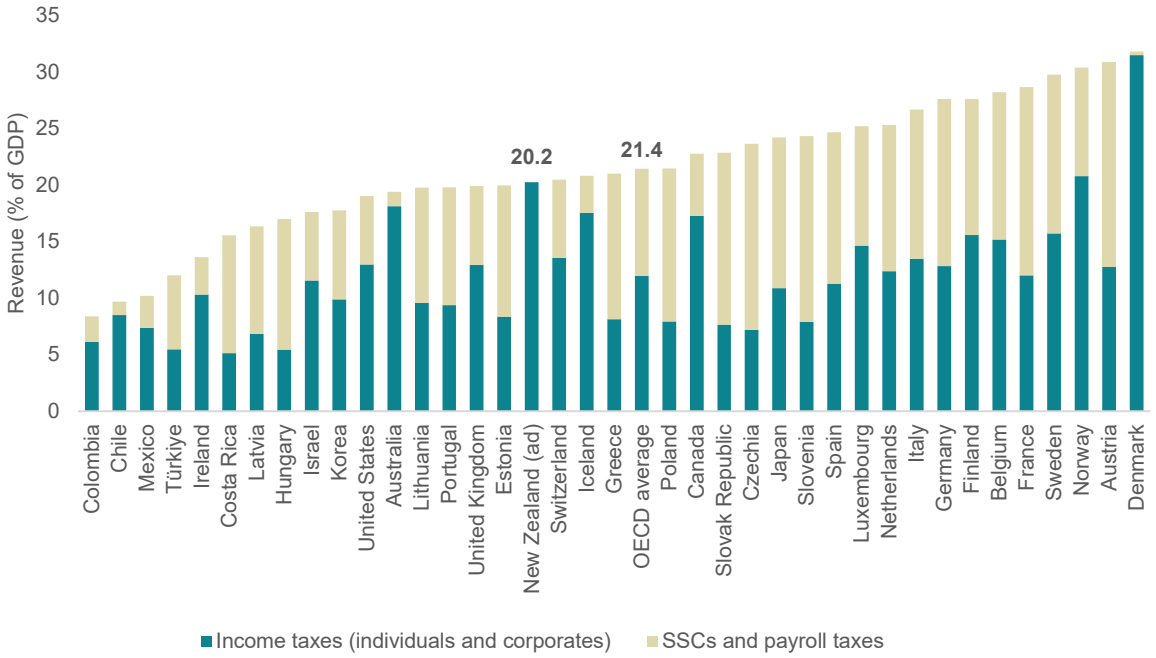
72. Figure 11 shows the composition of tax revenue in a country by looking at revenue from different tax sources as a proportion of total general government tax revenue. However, this does not give an indication of the total level of revenue raised relative to the size of the economy. Looking at tax sources relative to GDP takes account of differences in tax-to-GDP ratios between countries rather than just the composition of revenue.

73. Focusing on total taxes on income, New Zealand raises a similar level of revenue, relative to GDP, from these taxes compared to the OECD average. Figure 12 shows New Zealand raised 20.2% of GDP from these taxes in 2021 (or 21.2% when including ACC levies), compared to the OECD average of 21.4% of GDP.

74. As discussed, we define total taxes on income to comprise income taxes (on individuals and corporates), SSCs and payroll taxes. For these components, figure 12 shows that New Zealand sources a relatively high amount of revenue, relative to GDP, from income taxes on individuals and corporates compared to other OECD countries. However, many other countries raise significant revenue from SSCs and payroll taxes; with many OECD countries raising more than a quarter of tax revenue from these taxes. SSCs and payroll taxes have a similar effect to income taxes on wages and salaries, although they are generally linked to an entitlement to receive a future social benefit.

[18] Here we are referring to income taxes on individuals and corporates and excluding SSCs and payroll taxes.

Figure 12: Income tax, SSC and payroll tax revenue as percent of GDP, 2021



Source: OECD, 2024

75. Individual income taxes apply to both labour and capital income, whereas SSCs and payroll taxes only apply to labour income. Corporate income taxes apply to capital income, which may be earned by domestic residents or non-residents, but also some labour income, particularly for small- and medium-sized enterprises. The fact that, when combining income taxes, SSCs and payroll taxes, New Zealand raises a similar level of tax-to-GDP to the OECD average, despite New Zealand not having significant SSCs or payroll taxes, suggests that New Zealand may be imposing relatively high taxes on at least some forms of capital income and relatively low taxes on at least some forms of labour income compared to other OECD countries.

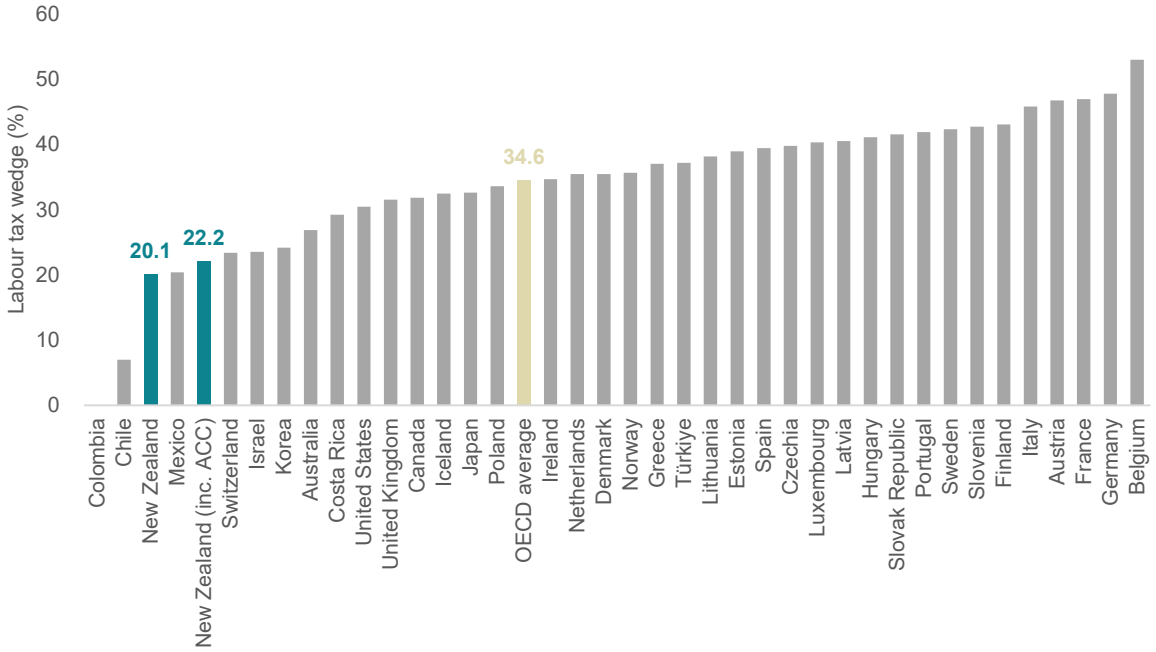
76. We can explore this further by looking at taxes on labour income in isolation. The OECD's annual publication *Taxing Wages* measures the average labour tax wedge, calculated as taxes on employees' wages net of transfers (income taxes plus employer and employee SSCs and payroll taxes minus cash benefits) as a proportion of the costs to employers of employing labour (gross wages plus employer SSCs). In short, it measures the burden of taxes on employees' labour income relative to labour costs. In the OECD analysis, wage earners are assumed to have standard employment contracts, and as such this measure does not cover the tax treatment of the self-employed, who in some countries have a different tax treatment, or those who earn labour income through entities such as companies.[19]

77. Figure 13 shows that New Zealand's average labour tax wedge is relatively low compared to other OECD countries. In 2022, the labour tax wedge for a single person without children at average earnings was 20.1% (or 22.2% if ACC levies are included) in New Zealand, compared to an OECD average of 34.6%. New Zealand's labour tax wedge relative to the OECD average was in a similar position for a single person without children at 67% and 167% of average earnings. By comparing to figure 9, we see that the countries with the highest labour tax wedge also have a high tax-to-GDP ratio,

[19] *Taxing Wages 2020* notes that employer liability for social insurance does not tend to extend to self-employed workers in the countries the OECD investigated. Employee social contributions can also vary across employment forms. However, self-employed workers not covered by SSCs may need to self-insure (OECD, 2020).

suggesting that high tax-to-GDP ratios are sustained in part through high taxes on labour.

Figure 13: Labour tax wedge as a percent of labour costs (single person without children at average earnings), 2022



Source: OECD, 2024

78. Similarly, if we just look at income taxes levied on individuals (that is, taxes on wages, self-employment income and capital income taxed in the hands of individuals), as well as employer and employee SSCs and payroll taxes, these taxes as a percent of GDP are relatively low in New Zealand (being 14.1% of GDP versus 17.8% for the OECD average in 2021).[20] This is consistent with New Zealand having a low tax wedge on employee's labour income compared to other OECD countries and suggests we might be capturing relatively less tax at the individual level rather than entity level, which we investigate below.

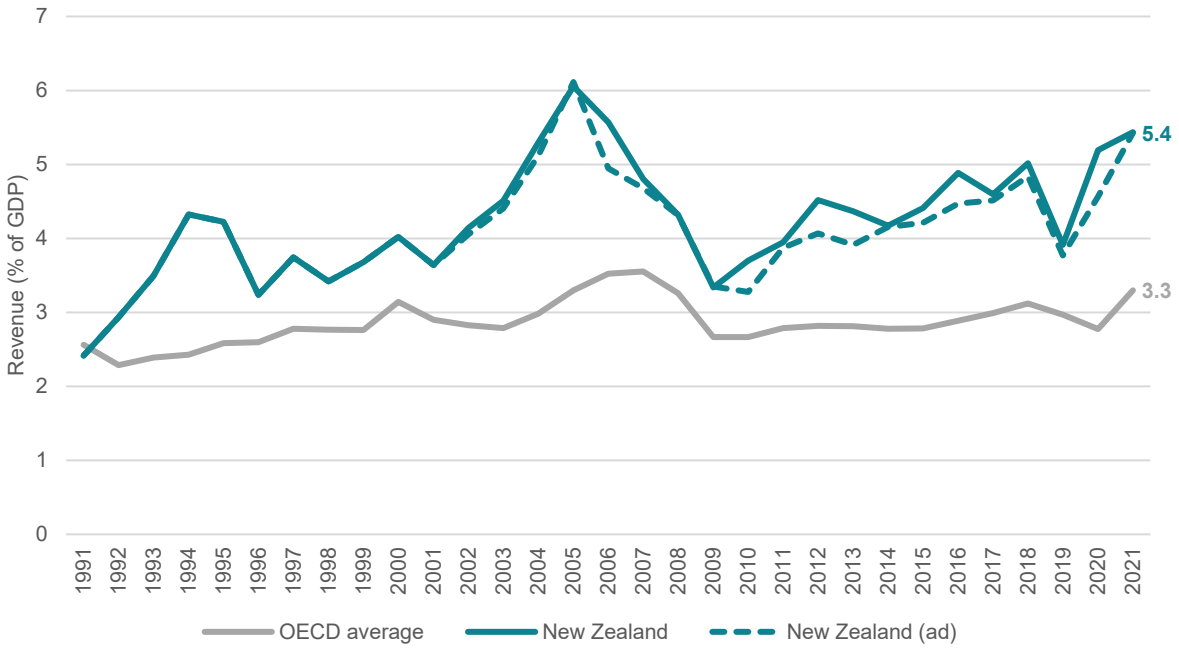
79. The OECD does not publish data enabling us to look in isolation at total taxes on capital income (that is, income earned on things people own). However, New Zealand raises more revenue from corporate income taxes as a proportion of GDP compared to the OECD average (the level of corporate tax to GDP will vary with the level of incorporation as well as the tax rate). In 2021, New Zealand raised 5.4% of tax revenue from corporate income taxes as a proportion of GDP compared to the OECD average of 3.3%. Corporate income tax revenue has been relatively volatile over the past 30 years, but New Zealand's revenue from corporate tax, relative to GDP, always exceeded the OECD average over this period, as shown in figure 14. "New Zealand (ad)" here removes tax paid by the NZSF and Government Superannuation Fund.

80. Considering capital taxes at the individual level, New Zealand's imputation system and lack of a general approach to taxing capital gains reduce the extent to which capital income is taxed at the individual level (see, for example, Hourani et al). The significance of corporate taxation in New Zealand, and entities such as PIEs, has implications for the extent to which domestic residents' income, particularly capital

[20] Figures on this page for individuals' tax and company tax exclude the category in the OECD data that is unallocated income whereas figure 16 includes this amount allocated 50/50.

income, is ultimately taxed at personal tax rates and for the effective tax rate on investment (in particular, because the corporate tax rate is the rate most relevant to non-residents investing into New Zealand), which is discussed at paragraph 95.

Figure 14: Corporate income tax revenue as a percent of GDP, 1991–2021



Source: OECD, 2024

81. New Zealand is unusual among OECD countries in not having a general tax on income from capital gains. A general capital gains tax was introduced in Australia in 1985. It raised A$25 billion in 2021–22, or around 1% of GDP.

82. Turning to consumption taxes, VATs are a widely used tax, being applied in over 170 countries worldwide and collecting around a fifth of global tax revenues (De la Feria & Swistak, 2024). New Zealand raises 1.7 percentage points of GDP more than the OECD average from general taxes on goods and services, after adjusting for GST on public services for comparability. In 2021, New Zealand raised 8.9% of GDP from such taxes (on a comparable basis), compared to the OECD average of 7.2%.

83. In terms of smaller tax bases, figure 15 shows that New Zealand raises more revenue as a share of GDP from recurrent property taxes compared to the OECD average, and less revenue as a share of GDP from taxes on financial and capital transactions, taxes on estates, inheritances and gifts, taxes on individual net wealth and non-general taxes on goods and services (that is, taxes on the consumption of goods and services other than general taxes like GST).

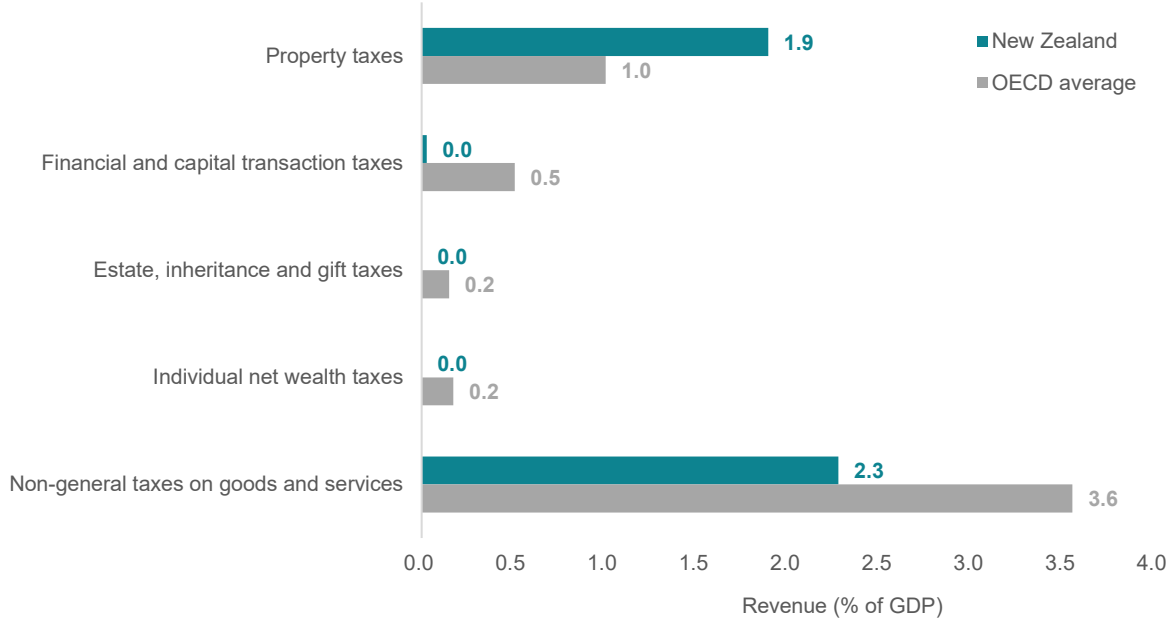
84. Every OECD country levies some form of recurrent tax on immoveable property. New Zealand does so in the form of local government rates, which raised 1.9% of GDP in 2021. Across the OECD, revenue from these taxes ranged from 0.1% (in Luxembourg) to 3.0% (in Canada) of GDP in 2021, with an average of 1%.

85. Over half the OECD countries levy taxes on estates, inheritances and gifts, raising 0.1% of GDP on average across the OECD in every year since 2000, except for 2021 where they raised 0.2% of GDP on average. As noted above, New Zealand abolished estate duty in the 1990s and gift duty in 2011.

86. Recurrent taxes on net wealth have become less common across the OECD over time. An OECD study published in 2018 noted that the number of member countries levying individual net wealth taxes fell from 12 in 1990 to four in 2017 (OECD, 2018). Switzerland raises the highest revenue from individual net wealth taxes as a share of GDP in 2021, at 1.2%. The OECD average is 0.2%. New Zealand does not have net wealth taxes.

87. Every OECD country levies some form of non-general tax on goods and services. Revenue from these taxes was 3.6% of GDP on average across the OECD in 2021, versus 2.3% of GDP in New Zealand. These taxes include specific taxes on goods and services, such as excise taxes and import duties, and recurrent taxes on the use of goods such as motor vehicles. New Zealand does not impose the latter.

Figure 15: Revenue from other tax bases as a percent of GDP, 2021

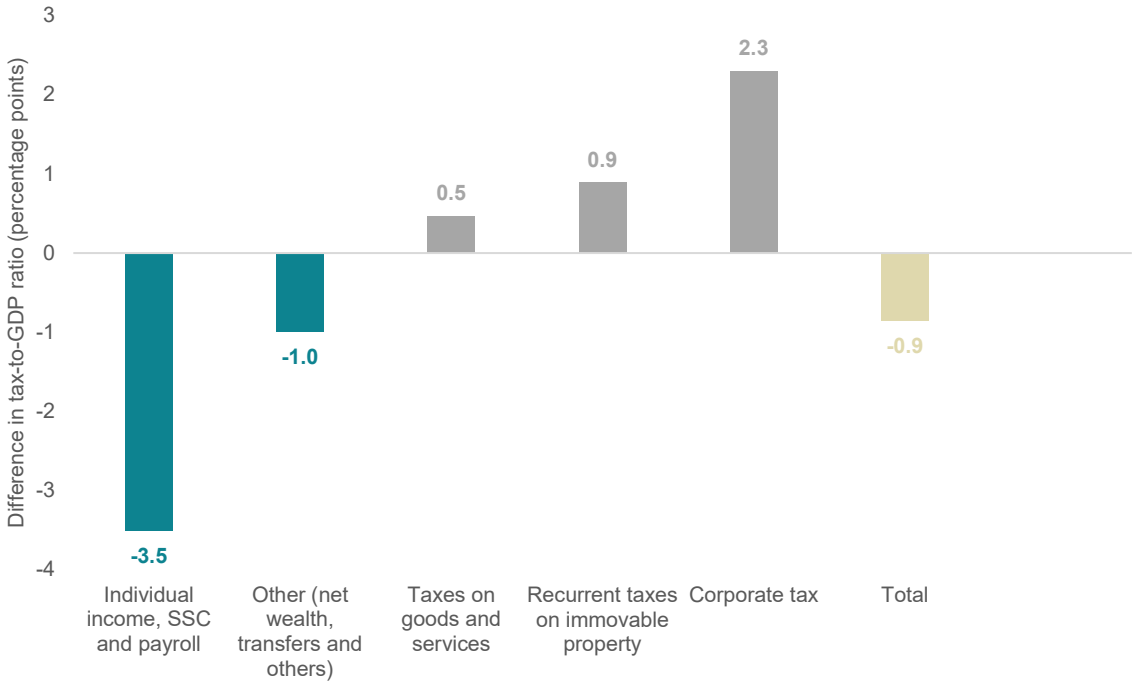


Source: OECD, 2024

88. As shown in figure 9, after adjusting for GST on public services, New Zealand's tax-to-GDP ratio is 0.9 percentage points below the OECD average. Figure 16 decomposes the elements of the 0.9 percentage point difference (figures do not add to 0.9 due to rounding). A negative number indicates the OECD average tax-to-GDP ratio is higher than the corresponding New Zealand figure. In sum, compared to the OECD average:

    - New Zealand has significantly lower individual level taxes as a portion of GDP when SSCs and payroll taxes are included.
    - New Zealand has lower taxes on net wealth and wealth and capital transfers as a portion of GDP.
    - For all taxes on goods and services (on a comparable basis), New Zealand raises slightly above the OECD average from these taxes as a portion of GDP.
    - New Zealand's level of recurrent property taxes (local government rates) is almost 1 percentage point of GDP higher than the OECD average.
    - New Zealand raises a significantly higher portion of GDP from corporate tax than the OECD average.

Figure 16: Decomposition of difference in OECD average tax-to-GDP ratio and New Zealand tax-to-GDP ratio, 2021



Source: OECD, 2024

Tax regimes

89. In terms of personal taxation, according to the classifications in an OECD study, New Zealand is one of eight OECD countries that operates a broadly comprehensive personal income tax system, in which labour and capital income are taxed at the same rate (Hourani et al, 2023).[21] Many other OECD countries operate a schedular system, in which different types of income are taxed at different rates. Dual income tax systems are a type of schedular system under which labour income is usually taxed at progressive rates while capital income (that is, income earned on things people own) is typically taxed at lower, flatter rates. Semi-dual systems tax some types of capital income at the same progressive rates as labour income while taxing other types of capital income at flat rates. Dual income tax systems are the most common system among the OECD countries.

Table 2: Classification of OECD personal income tax systems, 2022

Type of system	**Comprehensive**	**Dual income**	**Semi-dual income**	**Other**
Countries	Australia, Canada, Chile, Luxembourg, New Zealand, Switzerland, United Kingdom, United States.	Costa Rica, Denmark, Finland, Greece, Hungary, Iceland, Israel, Italy, Latvia, Lithuania, Netherlands, Norway, Poland, Slovenia, Spain, Sweden, Türkiye	Belgium, Colombia, Czechia, Estonia, Ireland, Mexico, Slovak Republic	Austria, France, Germany, Japan, Korea, Portugal

Source: Hourani et al, 2023

[21] Although as noted earlier, in New Zealand income earned through PIEs is taxed at a maximum rate of 28%, meaning not all capital income is taxed at the same rate.

90. In terms of the integration of corporate and personal taxation, New Zealand is one of six OECD countries in the OECD's classification that use a type of imputation system to adjust personal tax to account for corporate taxes on distributed profits. New Zealand's imputation system is described in paragraph 51.

91. The most common approach to taxing dividends in the OECD is the classical system, where no explicit adjustment is made to dividend taxation to account for corporate taxes. Instead, all distributed dividend income is taxable either at the personal income tax level (in some cases at a discounted rate) or through final withholding (tax is withheld by the distributing company and no further tax is payable at the shareholder level). Some countries operate a partial inclusion system, where a portion of distributed dividend income is tax exempt, and the remainder is taxed under personal income tax.

Table 3: Integration of corporate and personal taxation, OECD countries

Type of system	**Classical**	**Imputation**	**Partial inclusion**	**Other**
Countries	Austria, Belgium, Colombia, Costa Rica, Czechia, Denmark, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Israel, Japan, Lithuania, Luxembourg, Poland, Portugal, Slovak Republic, Slovenia, Spain, Sweden, Switzerland, United Kingdom, United States	Australia, Canada, Chile, Korea, Mexico, New Zealand	Estonia, Finland, Latvia, Türkiye	Netherlands, Norway

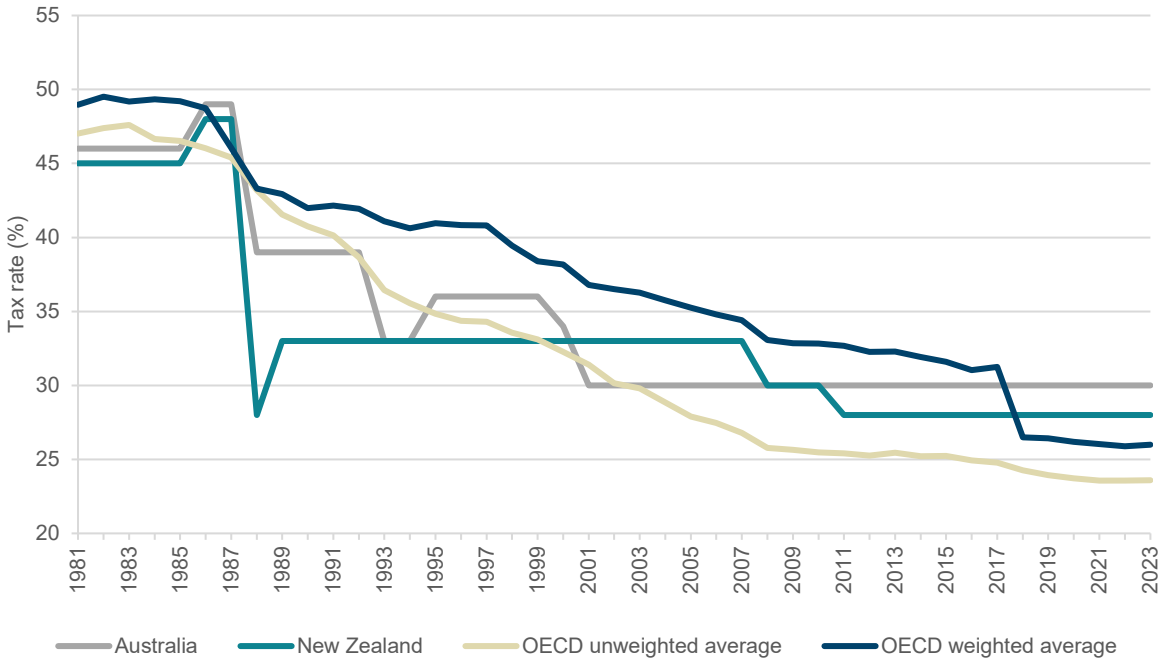
Source: Hourani et al, 2023

92. New Zealand's company income tax rate is currently higher than the OECD average, as shown in figure 17. In the late 1980s and 1990s, New Zealand's rate was lower than the average of those same countries, on both a weighted[22] and unweighted basis. Since then, although New Zealand has reduced its rate, many other OECD countries have reduced their rates by more, and New Zealand's rate is now higher than both the OECD weighted and unweighted averages (by 2 and 4.4 percentage points respectively).

93. In 2023, New Zealand had the eighth highest company tax rate in the OECD, taking into account company taxes levied at different levels of government. As noted above, New Zealand raises a relatively high amount of revenue from company income tax as a proportion of GDP compared to other OECD countries (which may be partly attributable to the level of incorporation).

[22] The weighted average is calculated by weighting rates by nominal GDP.

Figure 17: Statutory company tax rates, 1981–2023[23]



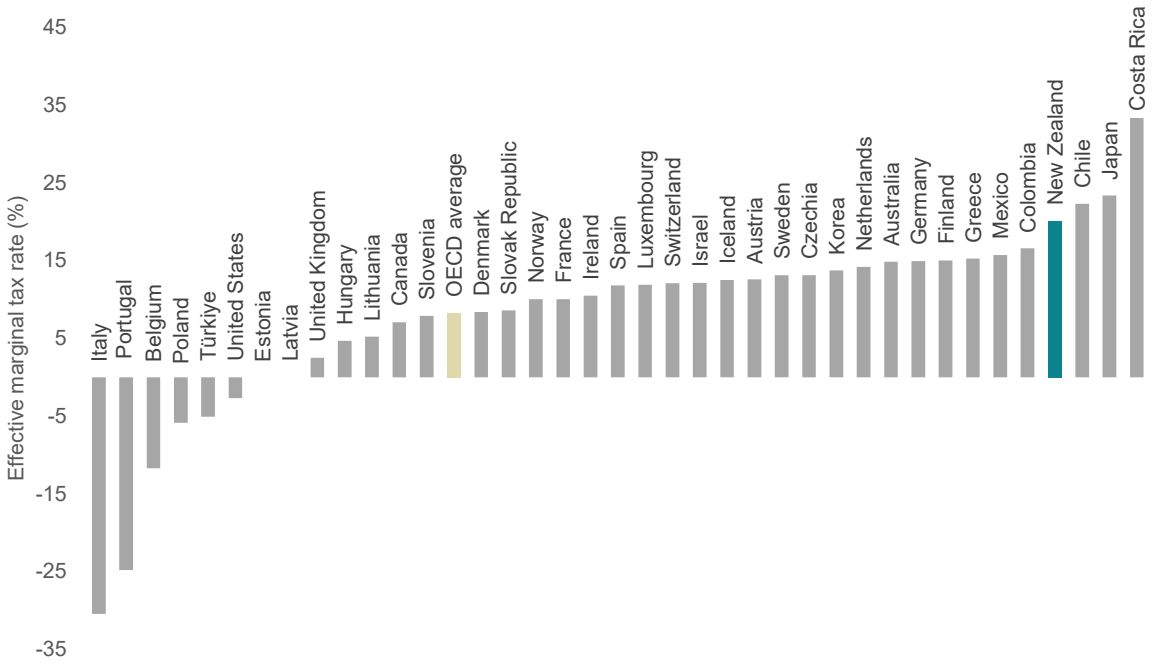
Source: OECD, 2024

94. New Zealand also has relatively high effective marginal tax rates on investments compared to other OECD countries. The effective marginal tax rate (EMTR) is the proportion of the real pre-tax rate of return on a marginal investment (that is, the last investment that it is profitable to undertake) that is lost in tax.

95. Figure 18 shows OECD calculations for the unweighted average EMTR across four asset classes (buildings, inventories, tangible assets and acquired intangibles), assuming a real interest rate of 3% and an inflation rate of 1%. New Zealand's rate was calculated for 2020 when depreciation deductions were available for non-residential buildings. Under this scenario, the OECD calculated that New Zealand's EMTR was higher than all but three other countries.

[23] Figure 17 shows average statutory combined central and sub-central government company tax rates for countries that were members of the OECD on 1 January 2024. The graph is based on data available in the OECD's database, which does not include data for every country in every year. Additional data has been sourced from the Oxford University Centre for Business Taxation, Tax Foundation and Trading Economics.

Figure 18: Effective marginal tax rate, 2020[24]



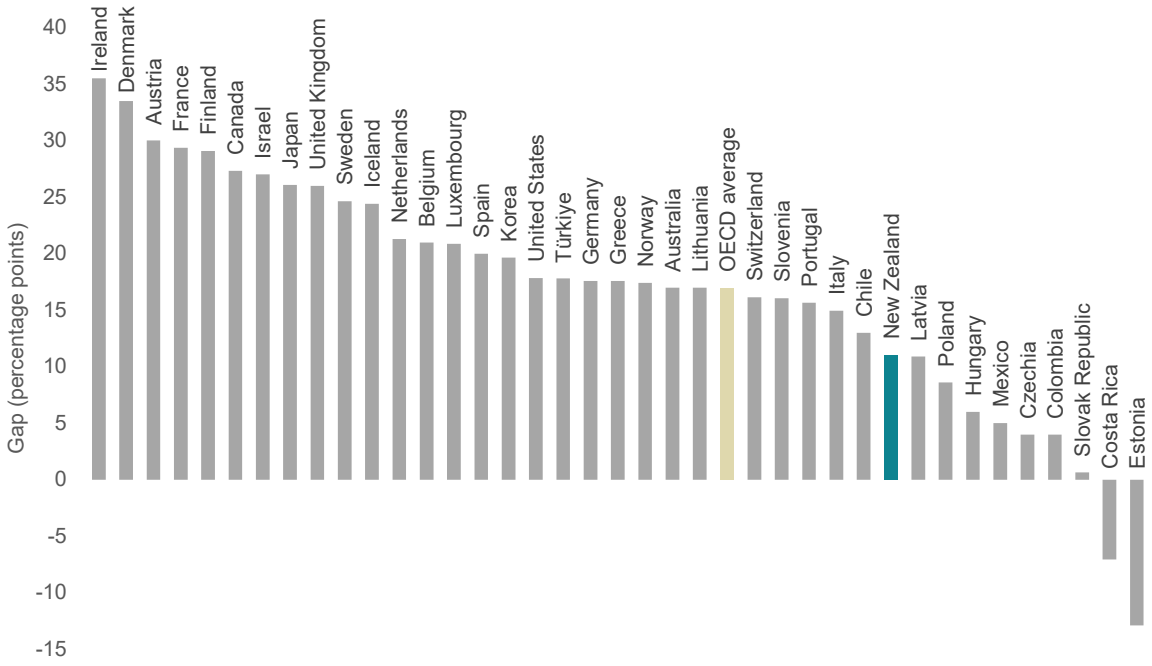
Source: OECD, 2024

96. New Zealand has a relatively small gap between its company tax rate and its top personal income tax rate compared to other OECD countries. A wider gap can increase incentives for taxpayers to shelter income in companies. The gap in New Zealand is currently 11 percentage points. Many countries have a much wider gap and manage the risks of income sheltering through measures such as capital gains taxes, limits on taxpayer discretion over the allocation of labour and capital income, retained profits taxes and general anti-avoidance rules.

97. Figure 19 shows the gap in OECD countries between the top personal tax rate, for a single person without dependents, and the company tax rate.[25] The top personal tax rate is calculated as the additional personal income tax resulting from a unit increase in gross wage earnings at the earnings threshold where the top personal statutory tax rate first applies. It does not include SSCs, which if included would result in a larger gap for some countries.

[24] See Hanappi (2018) for methodology.
[25] The combined top personal tax rate takes account of central and sub-central government taxes and the effects of tax credits, the deductibility of sub-central taxes in central government taxes, etc. The company tax rate is the combined central and sub-central government rate.

Figure 19: Gap between company and top personal tax rate, 2022



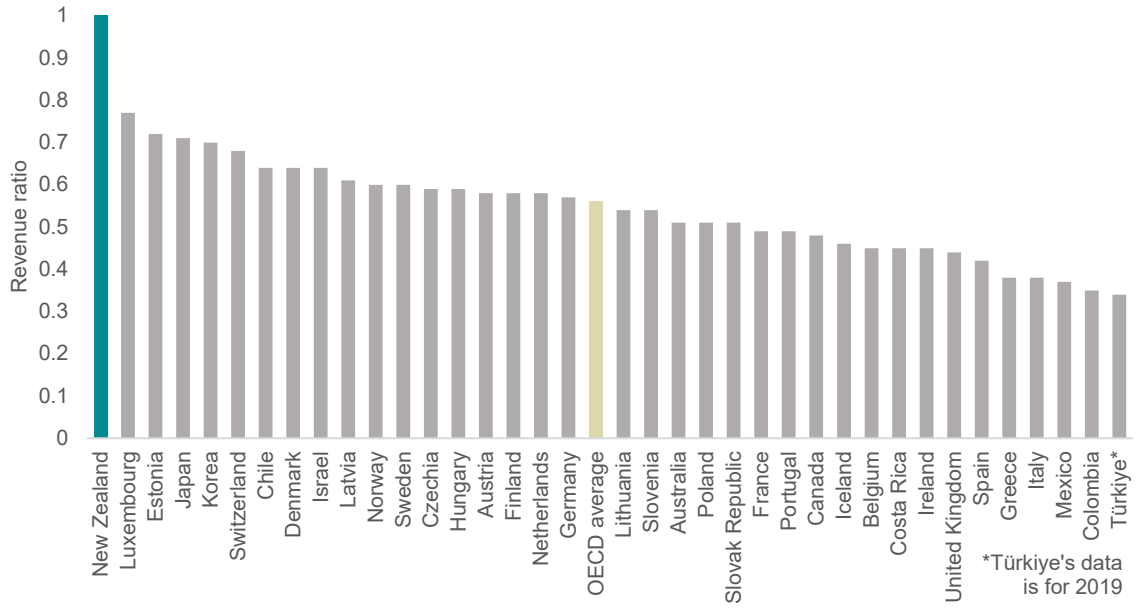
Source: OECD, 2024

98. New Zealand's GST regime is the broadest value added tax (VAT) regime in the OECD. As noted above, New Zealand's GST applies to almost all goods and services (including public services). Conversely, many other OECD countries' regimes apply reduced rates and exemptions to a wide range of goods and services such as necessities.

99. The OECD measures the extent to which a country's VAT regime applies VAT to all goods and services through a measure called the revenue ratio.[26] A higher ratio reflects a broad-based regime while a lower ratio reflects the presence of reduced rates and exemptions. Figure 20 shows that, in 2020, New Zealand's ratio was the highest in the OECD and significantly higher than the second highest ratio. New Zealand's high ratio is a consequence of our broad GST base, limited use of non-standard rates and the charging of GST on public services.

[26] The VAT revenue ratio is a measure of the comprehensiveness of a VAT base. It measures the difference between actual revenue and the revenue that would be collected if VAT was applied at a country's standard rate to all final consumption expenditure. It is calculated as: VAT Revenue / [(Consumption - VAT revenue) x standard VAT rate]. Consumption is Final Consumption Expenditure in national accounts.

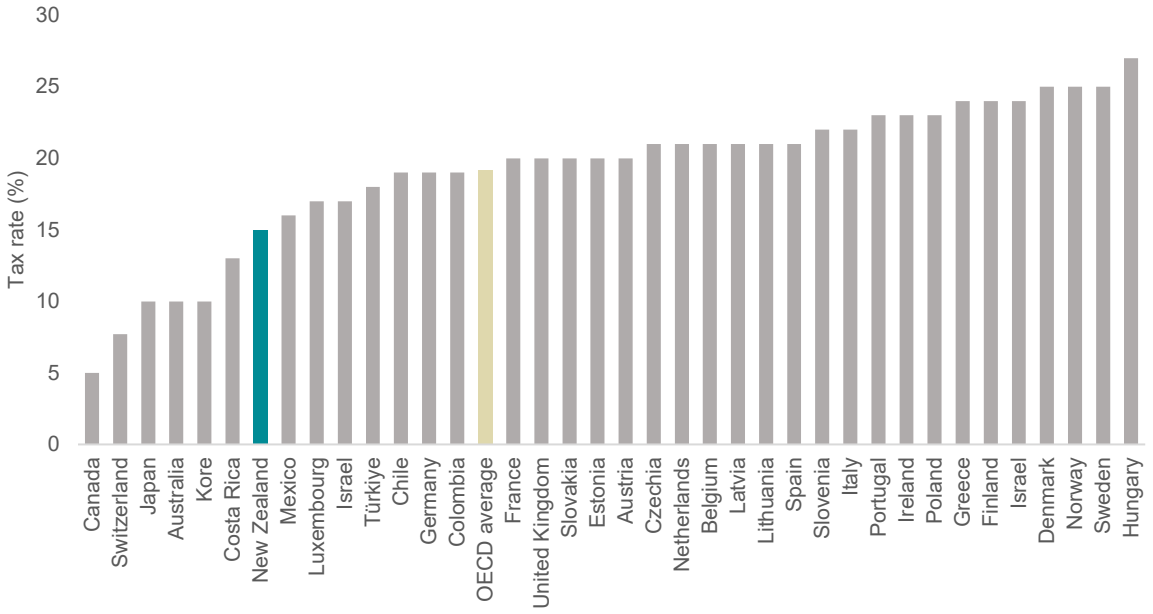
Figure 20: VAT revenue ratio, 2020



Source: OECD, Consumption Tax Trends, 2022

100. Figure 21 shows that New Zealand's standard GST rate is one of the lowest in the OECD. In 2020, standard rates of GST in OECD countries ranged from 5% in Canada[27] to 27% in Hungary. New Zealand's rate of 15% was seventh lowest. Despite this low rate, New Zealand raises a higher level of revenue from GST, relative to GDP, than the OECD average due to the lack of exemptions and reduced rates, as discussed above.

Figure 21: Standard rates of GST, 2022



Source: OECD, 2024

[27] Note, however, that most Canadian provinces levy specific sales taxes or Harmonised Sales Taxes alongside the Federal 5% GST.

Conclusion

101. New Zealand's tax system collects around a third of our GDP in tax revenue. Over 90% of central government tax revenue, and 87% of general government tax revenue, is raised from two main bases: income tax and GST. Within these bases, New Zealand has for many years followed a broad-based low-rate approach, which helps minimise economic distortions and administration costs. Previous reviews have noted the benefits of this approach, but have also identified tensions in the system, including around the comprehensiveness of our income tax bases and the interface of personal and entity tax regimes.

102. New Zealand's tax system raises a similar level of revenue, as a proportion of GDP, as the average of OECD countries. However, New Zealand's system is unusual in the OECD in not having significant specific taxes on labour income, such as SSCs or payroll taxes. Further, New Zealand's comprehensive income tax system generally taxes the labour and capital income of individuals at the same rate and utilises an imputation system to align taxation of dividends with personal tax rates. In contrast, many other countries operate schedular systems that tax capital income at a lower rate than labour income. Consequently, most OECD countries typically have a higher direct burden of tax on employee labour income than New Zealand. In particular, countries with high tax-to-GDP ratios tend to have a much higher tax burden on labour income from employment than New Zealand. In contrast, New Zealand's system has a higher company tax rate than the OECD average and high effective marginal tax rates on inbound investments. Further, recurrent taxes on property (levied through local body rates) are relatively high in New Zealand.

103. New Zealand's tax system relies on the taxation of both entities and individuals. The rates set at the entity level often reflect a trade-off between economic costs and the desire to align the taxation of domestic residents with the personal tax rates under our comprehensive income tax. The result is that not all capital income is ultimately taxed at personal tax rates. A question is – could other approaches better align these trade-offs? This is discussed further in chapter 3.

CHAPTER 2: CONSIDERATIONS FOR A FUTURE TAX SYSTEM

Introduction

104. Chapter 1 described New Zealand's tax system and compared it to tax systems in other OECD countries. This chapter discusses the major emerging trends that are likely to have implications for New Zealand's tax system over the next 50 years and examines how other countries are dealing with similar challenges.

Long-term trends – a global perspective

105. In its 2021 paper *The Long Game: Fiscal outlooks to 2060 underline need for structural reform*, the OECD considers future trends for OECD countries. Key trends identified in the report include slower real GDP growth for OECD economies, population ageing and higher relative prices for services (such as health care). These trends combine to produce an increase in fiscal pressures for OECD countries. These same drivers are also creating fiscal pressures in New Zealand. The OECD's projections put New Zealand close to the median in terms of forecast fiscal pressures.

Long-term trends in New Zealand

New Zealand's population is ageing

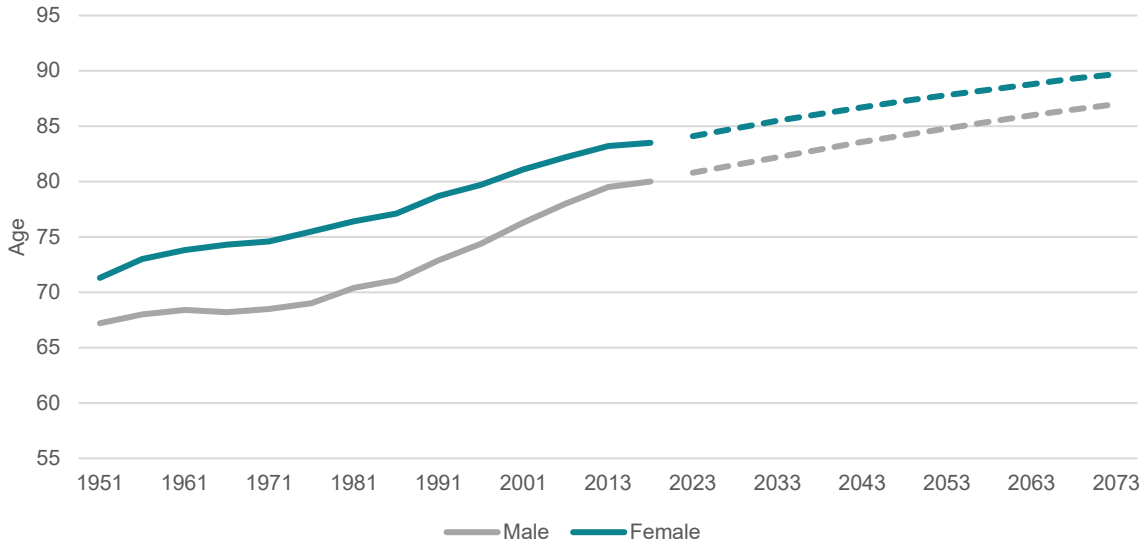
106. In Stats NZ's median population projection (2022 base), New Zealand's population is anticipated to reach over 6.0 million by 2048, and over 6.6 million by 2073. There are three key factors impacting New Zealand's future population: life expectancy, fertility and migration. Overall, these combine such that the future population will be larger and older.

107. Currently, the average (median) New Zealander is 38 years old, however by 2073 the average age is expected to be over 47 years old. An ageing population is largely due to two factors: lower death rates (that is, longer life expectancy – when combined with the "baby boomer[28]" cohort) and lower birth rates.

108. Figure 22 shows that life expectancy at birth has been increasing for many decades and is projected to continue to increase. This is due to a wide range of social factors including access to health care, education, and healthier lifestyles. Better medical treatments, awareness of risk factors and lower child mortality have all played a part. Healthy life expectancy (which subtracts years spent in poor health) is also increasing in New Zealand, but not at the same rate. Between 1990 and 2017, the time that someone at birth could expect to spend in poor health increased by 1.7 years for females and by 2.2 years for males (Ministry of Health, 2020).

[28] Defined as people born between 1946 and 1965.

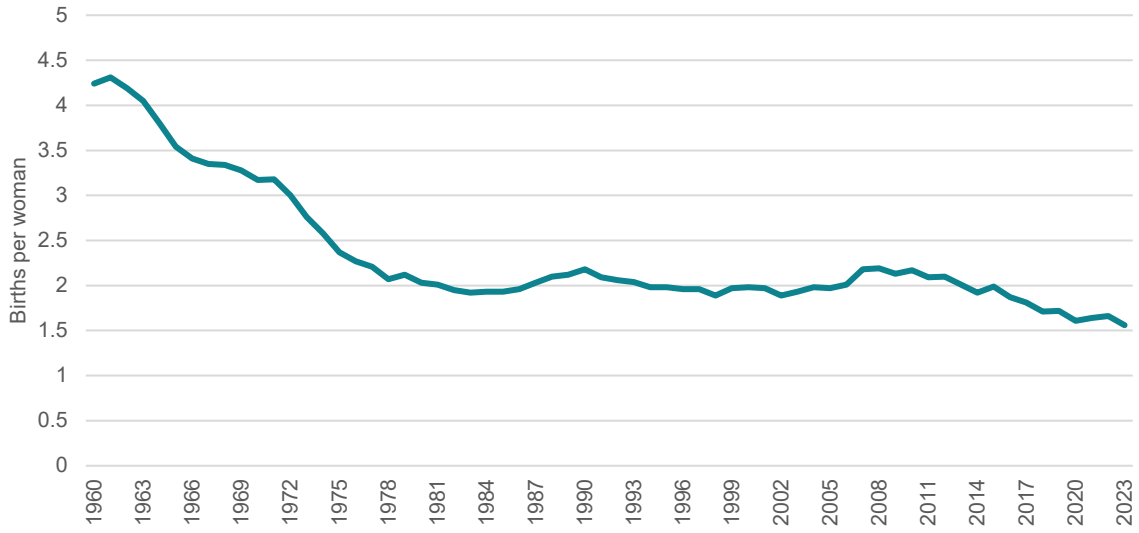
Figure 22: Life expectancy at birth, 1951–2073



Note: the data is in 5-year increments except between 2005–2007 and 2012–2014.
Source: Stats NZ, National and subnational period life tables, 2021 & National population projections, 2022 (June years).

109. New Zealand's current fertility rate[29] of 1.56 live births per woman (December 2023) is below the natural replacement rate of 2.1 live births. Figure 23 shows that New Zealand's fertility rate has been in decline for some time, first falling below 2.1 live births in 1978 (and since 2013). New Zealand is not alone in experiencing a sustained weakening of its fertility rate, with countries such as Australia, Canada, the United Kingdom, Japan and the United States, amongst others experiencing similar reductions in newborn children.

Figure 23: Fertility rate, 1960–2023



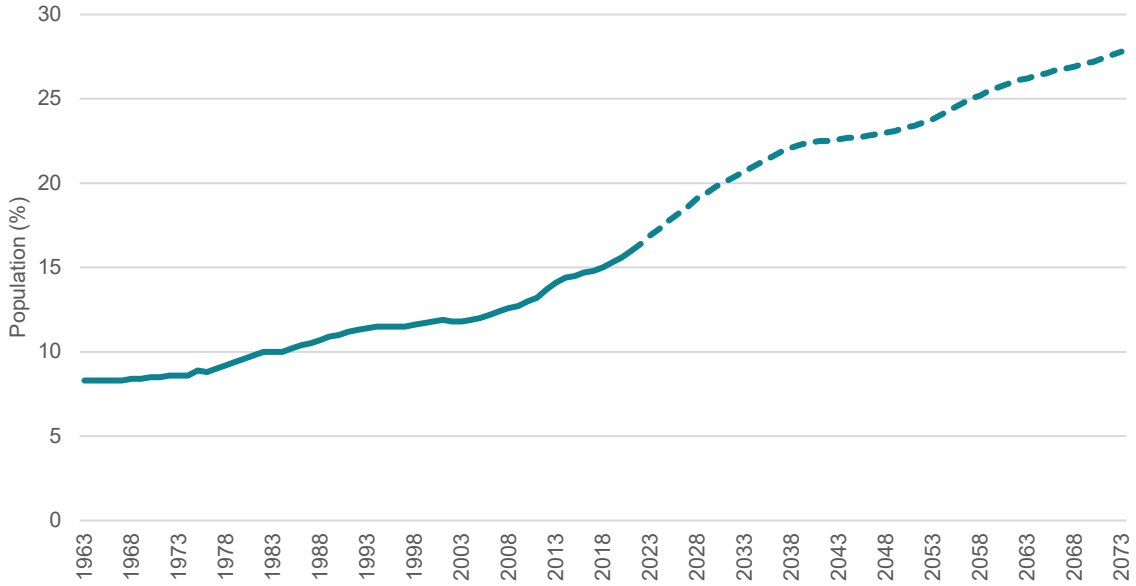
Source: Stats NZ, Births and deaths, 2024 (December years)

[29] In most countries, the replacement fertility level is roughly 2.1 live births per woman because not everyone reaches child-bearing age, but the exact number depends on gender ratios at birth and infant and child mortality rates. Migration trends are not taken into account.

110. Migration can also impact on the population age structure. Historically, New Zealand has had relatively high rates of migration, which has supported population growth. The average migrant tends to be younger, which slows population ageing (Stillman & Maré, 2009). However, the Treasury notes there is evidence to suggest that, over time, migrants are likely to shift towards having similar numbers of children as the population of the country they have moved to, mitigating this impact (The Treasury, 2021).

111. As a result of these trends, New Zealand's age structure is changing. Figure 24 shows that the proportion of the population aged 65 and over, compared to the total population, has been steadily increasing over recent decades and is projected to continue increasing.

Figure 24: Proportion of total population over 65, 1963–2073



Source: Stats NZ, National population projections, 2022 (June years)

112. The 65+ dependency ratio illustrates the changing age structure by relating the number of people over 65 to the working-age population (aged 15 to 64 years). The 65+ dependency ratio has increased over recent decades and is projected to continue to increase. In the mid-1960s, there were 14 people aged 65+ per 100 people aged 15 to 64. By 2022 it had increased to 25 per 100. By 2073, the ratio is projected to be 48 per 100 in the median projection (or 2.1 working aged people for every person aged 65 and over).

Future labour force

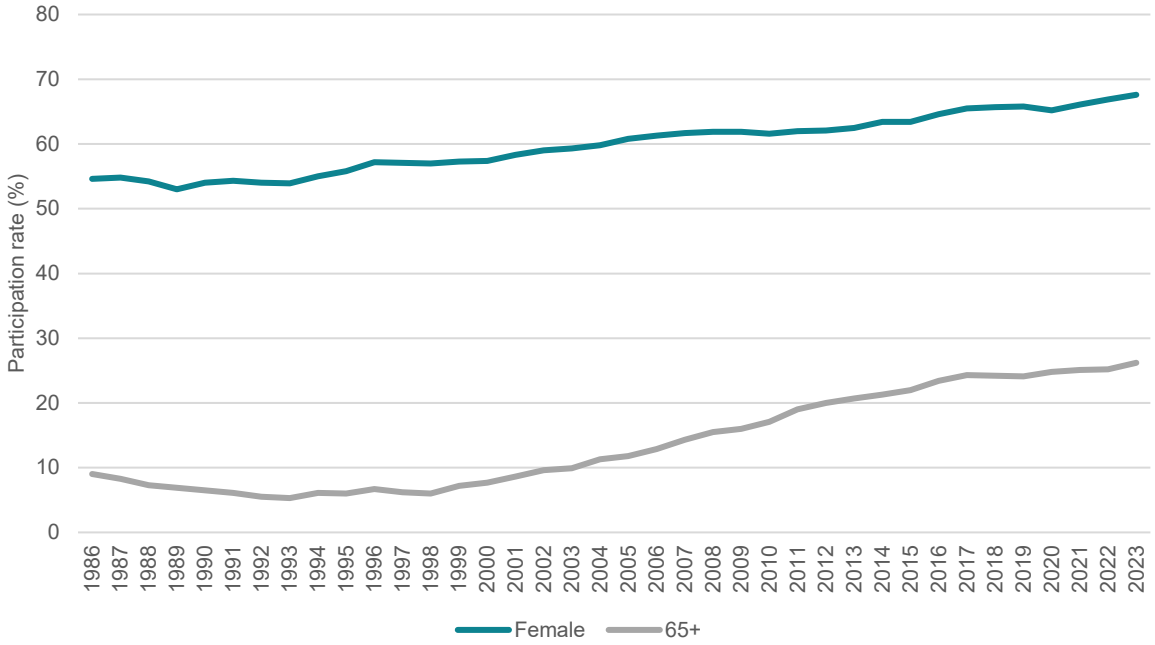
113. Over recent decades, two key factors impacting on the labour force have been increasing labour force participation of over 65s and increasing labour force participation by women. The labour force measures those over 15 years old who are working or seeking work.[30] The labour force participation rate measures the proportion of people in the labour force relative to the population (for those over 15).

114. Figure 25 shows that since the late 1990s, the labour force participation rate of those aged over 65 has increased – that is more over 65s are now working, or seeking

[30] The labour force includes people aged 15 years and over who regularly work for one or more hours per week for financial gain, people who work without pay in a family business, and unemployed people seeking work. Retired people are not in the labour force but over 65s who work, or are seeking work, are.

work, than in the past. We have also seen higher labour force participation from women, especially women of child-bearing age. Female participation rose 12.5 percentage points from 55% in 1986 to 68% in 2023. Factors driving this increase include higher female employment in traditionally male-dominated jobs, greater childcare support, and rising household costs.

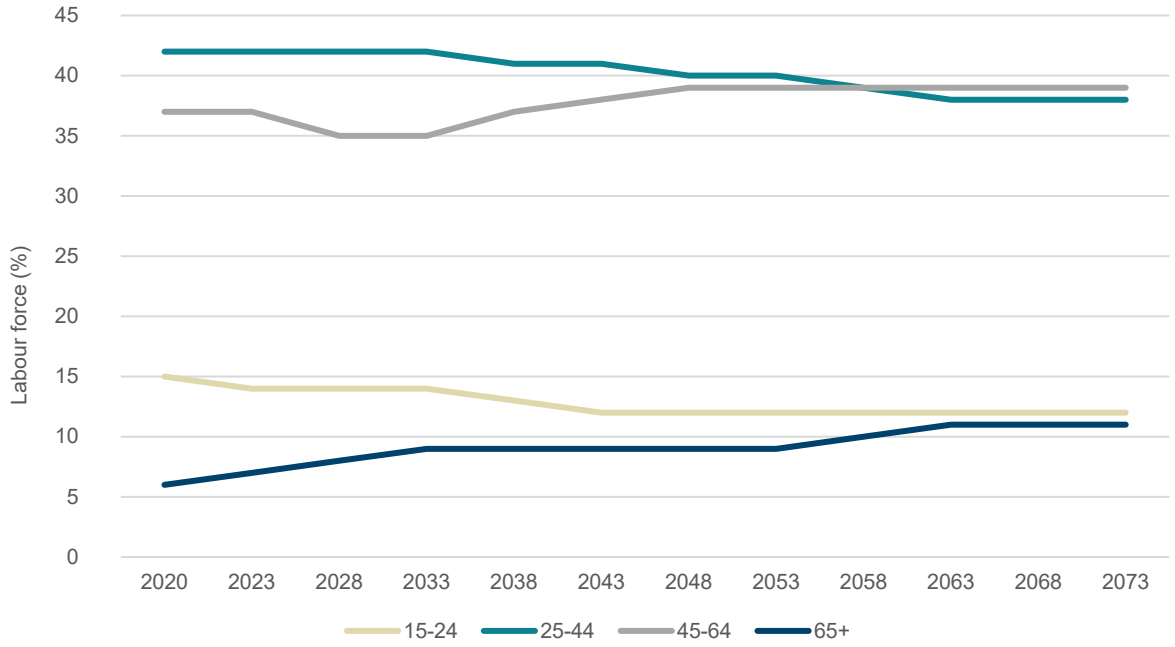
Figure 25: Labour force participation rate of people aged 65+ and females of all ages, 1986–2023



Source: Stats NZ, Household labour force survey, 2024 (December years)

115. Over the next 50 years, New Zealand's labour force is projected to grow, but the growth rate will slow in the long term. Under Stats NZ's median labour force projection (2020 base), the labour force grows from 2.9 million people in 2020 to around 3.7 million in the early 2070s. The age structure of the labour force is, however, projected to change with the proportion of over 65s nearly doubling, from 6% to 11%, while the proportion of under 45s declines from 57% to 50% in the median scenario.

Figure 26: Distribution of the labour force by age group, 2020–2073

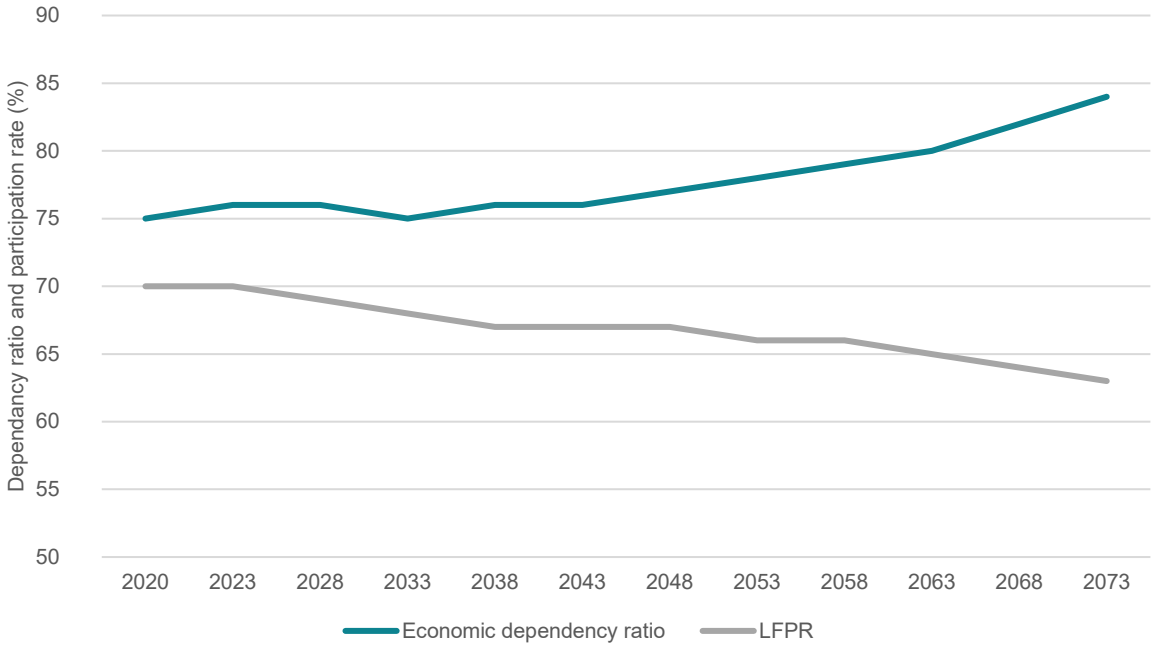


Source: Stats NZ, National labour force projections, 2021 (June years)

116. Stats NZ's labour force projections indicate that New Zealand is currently near peak labour force participation. Projections to 2073 (figure 27) show a declining overall labour force participation rate (LFPR) in the median scenario – that is, the number of people in the labour force relative to the adult population is likely to decline over the long term. Currently around 70% of adults are in the labour force whereas Stats NZ's median projection sees this decline to around 63% in 2073. This drop is despite assumptions of static or increasing labour force participation rates at most ages and is due to a greater proportion of the population at older ages where LFPRs are lowest (Stats NZ, 2021).

117. The economic dependency ratio measures the number of non-workers (including children) in a country relative to those working (it is the number of people not in the labour force per 100 people in the labour force). It aims to assess the economic burden on the workforce. Figure 27 shows that as the population ages, the economic dependency ratio is projected to increase.

Figure 27: Economic dependency ratio and labour force participation rate, 2020–2073



Source: Stats NZ, National labour force projections, 2021 (June years)

Economic growth is slowing down

118. The OECD's 2021 long-term economic projections project that real GDP growth rates will continue to decline across OECD and G20 countries. For the OECD, growth in real GDP is projected to decline from 1.75% per annum in 2019 to 1.25% per annum by 2045. On a per capita basis, which is a better measure of living standards, real GDP per capita growth is projected to remain stable at around 1% to 1.25% per annum. Weak growth is due mainly to lower population growth and a declining share of the population in work due to ageing (Guillemette & Turner, 2021).

119. A declining share of the population in work will reduce the contribution of labour input to economic growth compared to the past. Consequently, productivity growth will be an important source of economic growth as populations age. Labour productivity measures the amount of GDP produced per hour of work.

120. New Zealand has a low level of labour productivity compared to the average OECD country. Galt (2023) finds that, in 2019, New Zealand's level of labour productivity was only 62% of the median of a group of 19 OECD countries.[31] Despite relatively low labour productivity, Galt found New Zealand's income growth performed better than the median of that group from the late 1990s to 2019. Gross national income per capita[32] increased from 68% of the median of that group in the late 1990s to 81% of the median in 2019. Galt attributes New Zealand's relatively good performance to the following factors: an increase in the share of the population in employment, an increase in New Zealand's average export prices relative to import prices and a reduction in New Zealand's net international income deficit (net income earned from abroad).

121. While some aspects of New Zealand's improved income performance since the 1990s may be enduring, there may be natural limits to others. As noted above, Stats

[31] Australia, Belgium, Canada, Denmark, Finland, France, Germany, Ireland, Italy, Japan, Korea, Luxembourg, Netherlands, Norway, Portugal, Spain, Sweden, the United Kingdom and the United States.
[32] In contrast to GDP, (real) Gross National Income (GNI) accounts for relative changes in the price of imports and exports and income derived by residents outside New Zealand.

NZ projections see a declining share of the population in employment over the long term. This suggests productivity growth will be an important source of income growth for New Zealand going forward.

Fiscal pressures in New Zealand

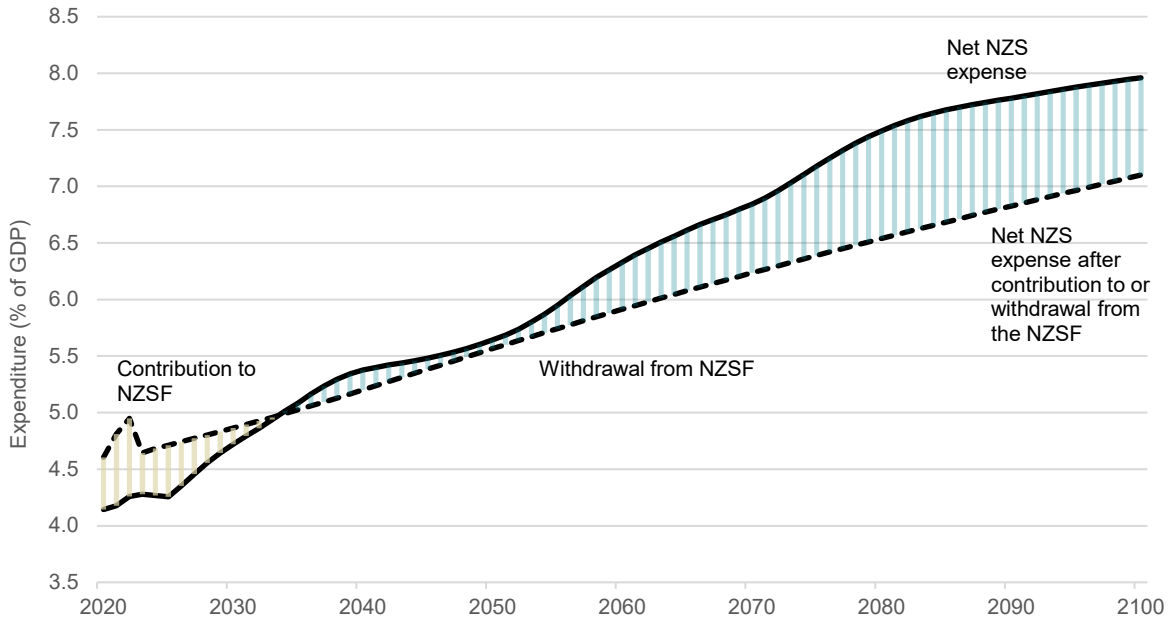
122. These, and other, long-term trends will create fiscal pressures in New Zealand. This includes pressures on government spending and potential revenue impacts. These fiscal impacts are reported on regularly in the Treasury's statement on the long-term fiscal position and are summarised below.

Expenditure pressures from pension and health care costs

123. As a higher proportion of New Zealanders become 65 years or older, the fiscal cost of New Zealand Superannuation (NZS), relative to GDP, will increase if current settings remain in place. The Treasury's 2021 Long-Term Fiscal Statement projected the net cost of New Zealand Superannuation to grow from 4.1% of GDP in 2020, to 6.3% of GDP by 2060 and 7.5% of GDP in 2080 based on current settings.

124. The New Zealand Superannuation Fund (NZSF) smooths some of the cost of superannuation. Since 2003 taxpayers have been contributing to the NZSF to meet some of the future costs of superannuation. In figure 28, the solid line shows the total net (of tax) cost of NZS (as a % of GDP) increasing over time. The dotted line shows the impact of NZSF contributions and withdrawals, and therefore the cost to the taxpayer (as a % of GDP) in any given year. Based on modelling in 2021, until about 2035, taxpayers are meeting the immediate cost of NZS and making additional contributions to the NZSF. After this point, the government is drawing down from the NZSF, meaning future taxpayers will only have to pay up to the dotted line rather than the solid line. Even with the NZSF, the cost to the taxpayer of NZS expenditure, relative to GDP, will increase if current settings remain in place.

Figure 28: Superannuation expenditure net of New Zealand Superannuation Fund



Source: The Treasury, 2021

125. The 2021 Long-Term Fiscal Statement also considered pressure on health expenditure. It notes that health expenditure has been rising significantly and this is likely to continue in the future. If government spending on health were to grow in line

with historical trends, health expenditure was projected to increase from 6.9% of GDP in 2020–21 to 10.6% of GDP by 2060–61. This increase reflects both demographic changes, as a growing and ageing population puts more pressure on the health system, and the fact that health expenditure tends to grow more quicky than income over time in most economies due to factors such as technology and wage pressure. This growth is consistent with international trends as modelled by the OECD.

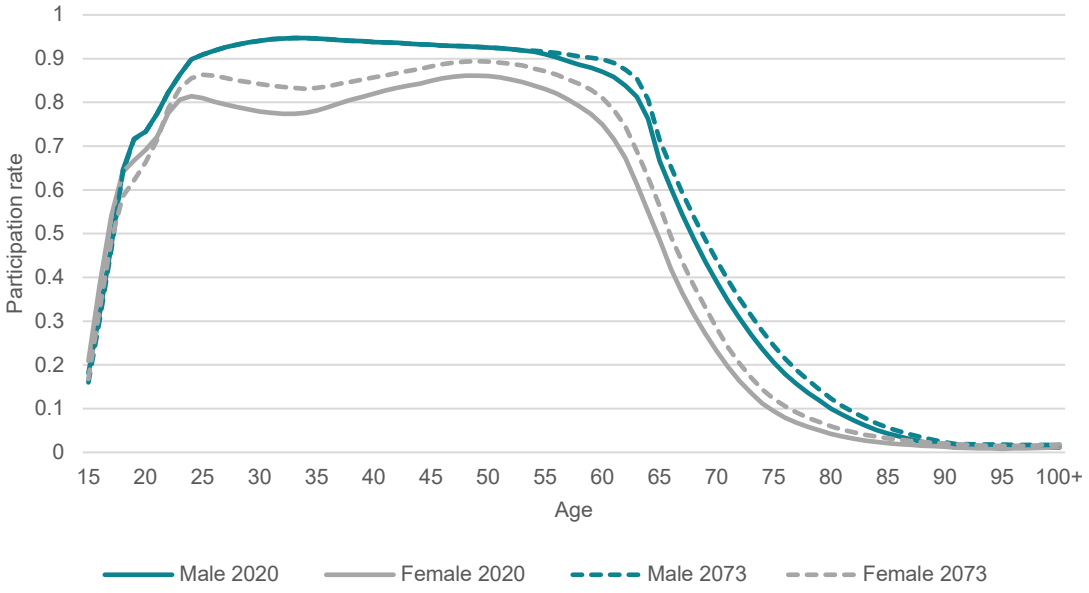
126. According to a 2013 Treasury background paper on long-term care and fiscal sustainability, long-term care expenditure (which includes rest-home care, home-based services to support older people and disability support services) constitutes around a fifth of all public health expenditure in New Zealand and stood at approximately 1.5% of GDP in 2013 (The Treasury, 2013). The paper notes that the sector is expected to face significant spending pressures over coming decades as the population ages. Projections under the Treasury's long-term fiscal model and by the OECD suggest that expenditure on long-term care could more than double over the next 50 years.

Revenue impacts

Impacts on tax revenues from a changing age structure

127. The ageing of the population will have impacts on the size of the income and consumption tax bases. However, there are complex effects. Research in New Zealand has suggested that the downward pressure on income tax revenue as retirees move out of the workforce would be partly offset by a higher proportion of the population moving through their peak earning years (45 to 54 age group) as shown in figure 26 (Ball & Creedy, 2013). The expected decline in the total population LFPR due to a greater share of the population at older ages (figure 27), is moderated by increases in LFPRs for women and those over 60 (figure 29). While retirees typically have lower incomes than workers, any impact on consumption will be offset to some extent by the spending down of retirement savings. Overall, we consider that the current evidence suggests that income and consumption taxes will have the capacity to gather significant revenue into the future. However, the impact of an ageing population on the size and mix of tax revenues is an area that would benefit from more research.

Figure 29: Labour force participation rates, by age and sex, 2020 and 2073



Source: Stats NZ, National labour force projections, 2021 (June years)

Revenue pressures from digitalisation

128. New platforms and business models have created opportunities for taxable activities to be delivered remotely by multinational companies based in any tax jurisdiction. This has eroded the domestic tax base and increased global tax competition, putting downward pressure on company tax revenues in New Zealand. The OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting is a multilateral work programme aimed at reforming the international tax system to address these issues. While some progress has been made it is likely that the underlying trends will continue to pose a risk to New Zealand's tax revenues.

Fiscal impacts of climate change and biodiversity loss

129. In 2023 the Treasury and the Ministry for the Environment published *Ngā Kōrero Āhuarangi Me Te Ōhanga, Climate Economic and Fiscal Assessment 2023.* The report notes that there will be economic costs from the physical impacts of climate change, as well as from the disruption arising from the transition to a low-emissions economy. Treasury modelling from the 2021 Long-Term Fiscal Statement suggested that by 2061, a higher frequency of droughts could have reduced GDP by 0.5% compared to the counterfactual (in the average of modelled simulations). A scenario with a higher frequency of storms and floods could additionally reduce GDP by about 0.7% by 2061. In the Treasury's median scenario, the impact of increased storms, floods and droughts, on both revenue and expenditure, was estimated to result in net core Crown debt being higher, than the counterfactual, by 3.77% of GDP in 2061, although there are large uncertainty bounds. Other fiscal pressures may include higher insurance costs, spending on improving the resilience of critical infrastructure, and costs associated with supporting managed retreat.

130. Action taken to achieve New Zealand's emissions targets (whether via regulation or spending) is also likely to slow economic growth and thereby impact revenue. The Climate Change Commission estimates that if its recommended emission reductions are achieved, GDP in 2050 will be about 1.2% lower than in a scenario with slower action to reduce emissions (Climate Change Commission, 2023).

131. There could also be significant economic impacts from biodiversity loss and ecosystem collapse. This is an area where New Zealand may be particularly exposed given the size of our food and fibre and tourism sectors and their dependence on nature and biodiversity. Researchers at the World Bank have concluded that an ecosystem collapse would cost about 2.3% of global GDP annually by 2030 (Johnson et al, 2021).

Impacts on tax revenue from disruptive technology

132. The gig economy, increasing automation and digitalisation, artificial intelligence and other disruptive technology are likely to change the nature of work and have implications for our tax bases and how we collect taxes.

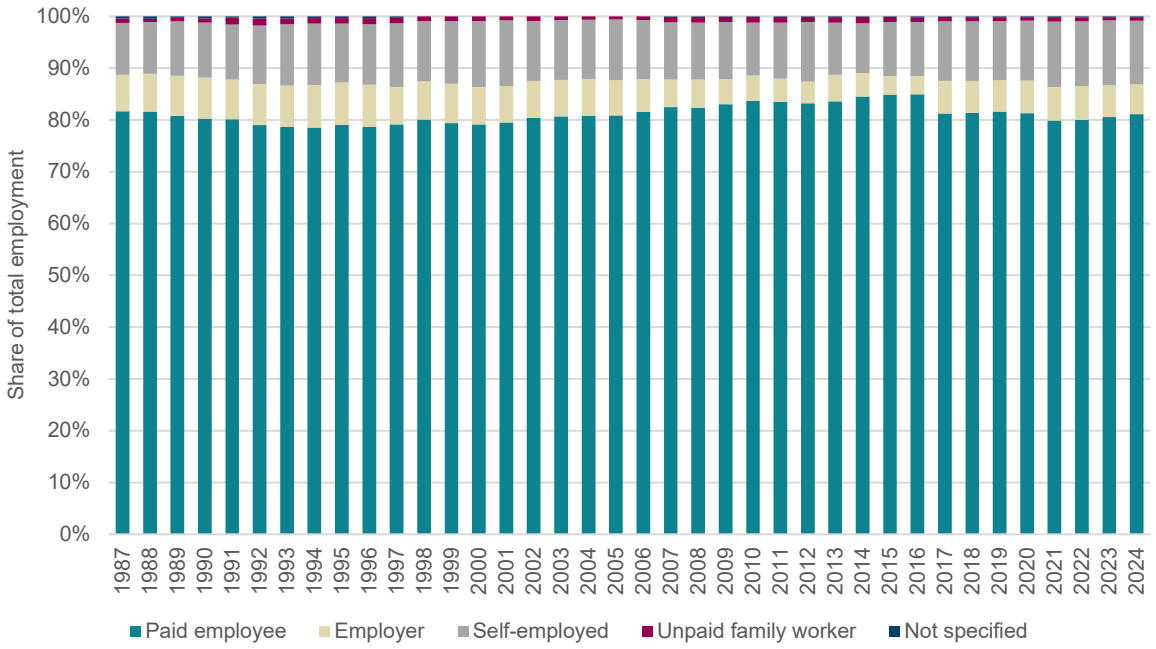
133. As one example, artificial intelligence has the potential to expand automation throughout the economy, potentially displacing jobs in multiple sectors. Impacts are highly uncertain however, some posit that one outcome could be a reduced labour share in national incomes and increased share for capital (Brollo et al, 2024). If this were to happen, our tax system may need to adjust by relying more heavily on taxes on capital.

134. As another example, a decrease in work organised through employment relationships and an increase in casual work, including in the use of independent workers for temporary contracts (the gig economy), could make it harder to collect income tax. However, as figure 30 shows, there does not appear to have been a significant structural change in the nature of employment relationships – with only

around a 3-percentage point variation in the share of self-employed over the last 25 years.

135. We consider issues arising from disruptive technology and the changing nature of work are either most relevant to tax administration (which we do not intend to focus on in the next LTIB) or have highly uncertain impacts. So, we propose not to consider the impact of these factors further in the LTIB.

Figure 30: Proportions of employment type, 1987–2024



Source: Stats NZ, Household labour force survey, 2024 (March years)

Policy options to address fiscal pressures

136. It is proposed that our 2025 LTIB is focused on what a suitable tax system for the future would be, given the trends discussed in this chapter and matters identified in chapter 1. One consequence of future fiscal pressures is that the tax system might be called upon to lift revenue raised as a percentage of GDP. But raising the tax-to-GDP ratio is only one possible response to fiscal pressures. Policy changes that reduce spending growth or increase GDP per capita are another possible response. Below we look at policy changes that could mitigate fiscal pressures from an ageing population that have been considered by other countries.

Lifting employment

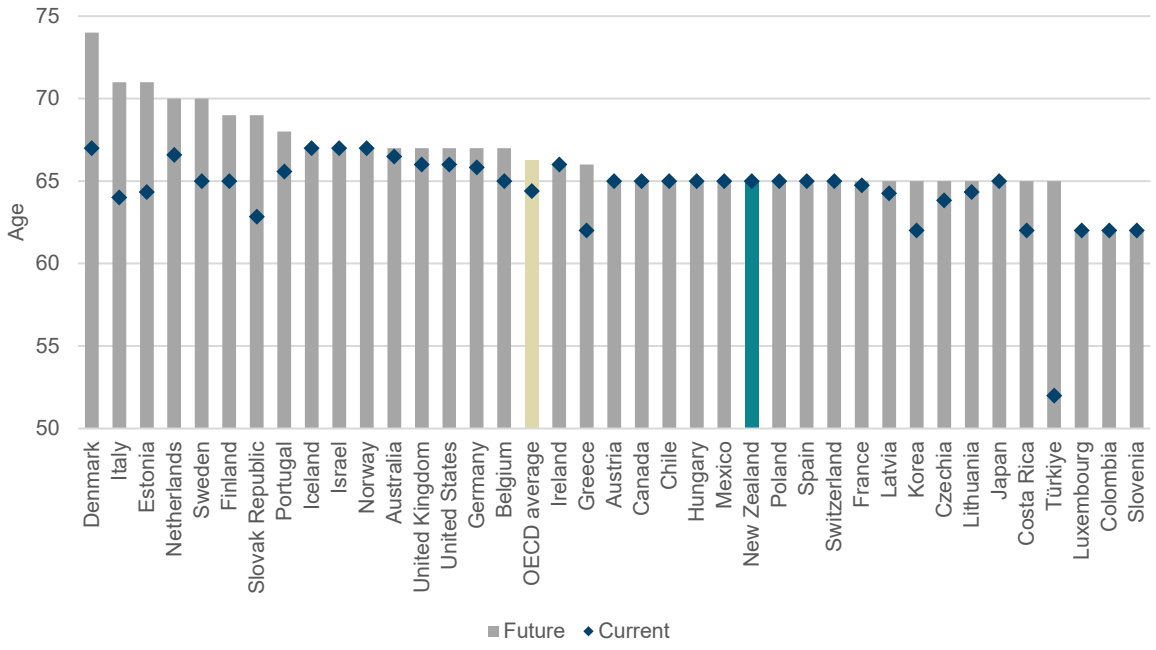
137. The OECD estimates that labour market reforms that lift employment in OECD countries could boost per capita GDP growth and thereby reduce fiscal pressures (Guillemette & Turner, 2021). Examples of policy measures that raise employment generally include active labour market policies, family benefits, maternity leave, subsidised childcare and lower tax rates on work. Removing higher tax rates for secondary earners also improves workforce participation. Measures specifically aimed at increasing employment by encouraging longer working lives, other than lifting the retirement age discussed below, include encouraging employers to retain or hire older workers, retraining programmes to help older workers acquire new skills, and programmes to improve health at older ages.

138. New Zealand's policy settings already incentivise the employment of older workers. Unlike many other countries, the universal nature of New Zealand Superannuation means older individuals need not retire at 65 years old to be entitled to New Zealand Superannuation (Hurnard, 2005). Figure 25 shows that New Zealand's labour force participation rate amongst individuals aged over 65 has increased since the late 1990s.

Extending working lives

139. Many OECD countries have taken decisions to gradually lift the age of retirement. This could reduce fiscal pressures by both reducing the cost of superannuation and improving labour force participation. The eight countries with the highest future retirement age have all linked retirement age to changes in life expectancy. Other trends include the gradual disappearance of gender differences in retirement age, and the restriction or elimination of early retirement options.

Figure 31: Current and future retirement ages[33]



Source: OECD, 2023

140. Considering changes to the age of eligibility for NZS is one option for New Zealand. Another option is to consider whether to shift the existing policy balance between universal and contributory retirement support. The OECD classifies country pension models into three tiers: publicly provided pension schemes (Tier 1); mandatory personal retirement savings schemes (Tier 2); and voluntary personal retirement savings schemes (Tier 3). New Zealand is an outlier among OECD countries in relying primarily on a Tier 1 scheme for retirement income support. New Zealand and Ireland are the only two OECD countries not to have a Tier 2 scheme, and New Zealand's tax treatment of Tier 3 schemes is among the least generous in the OECD (Coleman, 2011).

Tax and growth

141. One issue to consider in choosing how to address long-term fiscal pressures is whether the literature provides clear conclusions as to how higher levels of taxation

[33] For a male with a full career from age 22.

and expenditure may impact on the level of income per capita in New Zealand. Macro-economic level studies have provided mixed results, for two main reasons.

142. First, it is difficult to quantify the impact the level of taxation has on GDP growth, because:

- while higher levels of taxation are typically correlated with higher GDP, causality either way is difficult to determine
- factors such as education and infrastructure development (which are funded by tax) may be more important in determining income levels than tax, and
- other policies, such as regulations, may in some cases have similar impacts to taxes, making cross-country comparisons difficult.

143. Second, governments levy tax to fund welfare enhancing expenditure, and the negative impact of taxes may be offset by the growth enhancing effect of government expenditure (Barro, 1988). Some studies show that a minimum level of tax capacity is needed to support sustained GDP growth (Gaspar et al, 2016). Given this, recent literature has focussed on what types of tax mixes have the least cost, in terms of economic growth and efficiency, rather than on the overall level of taxes and expenditure. For example, work by the OECD suggests in OECD countries (over the period 1980 to 2014) that the tax mix can have significant impacts on a country's long-run growth (Johansson et al, 2008).

144. Given these considerations, we propose that the LTIB focus on understanding the desirability of different tax mixes (that is, the sensible set of tax bases and their relative economic cost), rather than the overall level of taxation.

Conclusion

145. Demographic trends and other factors will create pressure for government spending to increase as a percentage of GDP over the coming decades. If spending were to lift as a percentage of GDP, the tax system would need to respond accordingly. While it is not a given that fiscal pressures will result in higher government spending as a percentage of GDP over time, these trends create uncertainty as to future revenue needs and mean that fiscal sustainability is an important issue for our tax system over the longer term.

CHAPTER 3: PROPOSED LONG-TERM INSIGHTS BRIEFING TOPIC

A suitable tax system for the future

146. Given the matters raised in chapters 1 and 2, we propose that Inland Revenue's next LTIB explores what broad structure of the tax system would be suitable for the future.

147. In our view, a suitable tax system for the future is one that can raise the amount of revenue required while keeping the costs of raising that revenue as low as possible (efficiency) and meeting the government of the day's equity goals in terms of the distribution of the tax burden. It should also be a system that is fit for purpose for different cohorts in society, for example serving Māori communities well.

148. We propose that our focus in the next LTIB be on revenue raising taxes. We do not plan to look in depth at specific taxes that are primarily aimed at changing behaviour (corrective taxes), such as reducing environmental harms or at windfall taxes. While these taxes also raise revenue, they raise different policy issues from revenue taxes. Revenue raising taxes are a large topic in themselves. Further, environmental taxes were looked at in depth in the Tax Working Group's 2019 report and since that time an inter-governmental environmental tax framework has been developed.

149. We consider the following are important in considering how to design the (revenue raising) tax system for the future:

- fiscal sustainability over the long term
- economic outcomes (efficiency and productivity), and
- distributional outcomes (equity).

150. Given expenditure pressures from an ageing population, a key issue is how the tax system contributes to fiscal sustainability over the long term. Future governments have the option to address long-term fiscal pressures through expenditure control, wider use of user-pays or private funding mechanisms or increases in the tax-to-GDP ratio. Because we do not know what choices will be made, we do not know for certain what future revenue needs will be and whether they will be higher than now or not. However, we will have a more resilient fiscal system if our tax system can easily adapt to meeting different revenue requirements over time – that is, if we have a flexible tax system. This would allow a gradual adjustment to long-term fiscal pressures if, and when, they emerge.

151. Flexibility could also be considered from a distributional point of view. Different governments are likely to take different views on how to distribute the tax burden over time, so the tax system needs to have a level of flexibility to meet different distributional goals over time.

152. However, it is also important to have stability in the core tax structure to provide certainty so individuals and businesses can make decisions. Frequent large-scale changes in the tax structure are likely to be costly to society.

153. We therefore consider that the tax system of the future needs to be one with a stable core structure of bases but with flexibility to adapt to changing revenue needs and distributional goals over time. Our tax system currently displays some flexibility to achieve different revenue levels and distributional goals. Figure 1 showed core Crown tax revenue as a proportion of GDP has varied around 7 percentage points over the last 30 years (due to both cyclical factors and policy changes). Further, changes in

the structure of the personal income tax system have been the main way governments have implemented different goals in terms of the distribution of the tax burden.

154. However, a key element of flexibility is the ability to adjust rates on the main tax bases to change the level of revenue generated by the tax system. While it might be thought that any tax system is inherently flexible due to the ability to adjust rates, there are significant constraints on doing this in New Zealand's current tax system.

155. In particular, there are some tensions in our current income tax system that may limit its flexibility to achieve different revenue levels through rate changes and may have implications for productivity and equity. These are:

- Integration of the personal tax system and taxation of entities. There is a tension between the efficiency and productivity objectives of supporting investment, and distributional and revenue objectives in how the entity and personal tax regimes interact. For example, to attract foreign investment, which is important to support productivity outcomes, it is important that the company tax rate not be too high. However, to support distributional and revenue goals, the personal tax system has a progressive marginal rate structure, and the top personal rates currently exceed the company rate of 28% (see *Table 1*, chapter 1). While the rate differential recognises these competing objectives, it also allows for income to be sheltered in companies and other entities, restricting options to raise revenue.

- Comprehensiveness of the income tax base. While New Zealand's income tax base is broad, there are gaps in the base. Specifically, New Zealand does not have a general tax on some forms of income, for example capital gains. This may constrain the ability to adjust rates to meet differing revenue levels by, for example, providing ways to recharacterise higher taxed income into a different form.

156. These features of the tax system may restrict a future government's ability to increase revenue through the income tax system while also achieving equity goals. Alternatively, it also restricts our ability to lower effective tax rates on foreign investment below rates on domestic residents to support productivity goals. Therefore, we consider that a key issue to consider is whether there are alternate income tax design features/regimes that may allow for a more flexible revenue system or better balance these trade-offs. Given these trade-offs and future revenue needs, we think that the tax system of the future needs to be able to manage a level of difference between top personal and entity rates.

157. Value added consumption taxes (VAT)[34] have become a more important part of the tax mix in New Zealand and other OECD countries over time. Reasons cited for their popularity include their capacity to raise revenue, along with their perceived efficiency and neutrality (De la Feria & Swistak, 2024). However, as a flat tax relative to expenditure, concerns are often raised about the impact of increases in VAT rates on low-income households. If these concerns are persuasive, they may reduce the flexibility of using GST as a way of responding to long-term fiscal pressures. Therefore, we propose to consider measures that might sit alongside a GST increase that could reduce the impact of rate increases on low-income households. This would include, for example, consideration of approaches to providing low-income offsets to compensate for GST rate increases.

158. Another key consideration for our future tax system is what might be the right mix of tax bases that form the core structure of the tax system. This question is relevant at current revenue levels, but a question to explore is whether different tax bases may have greater justification at higher revenue levels and, if so, the relative merits of raising rates on the main bases versus adding new bases if revenue needs substantially

[34] GST in New Zealand.

increased. Further, if the flexibility of our current bases to changing revenue needs is not increased, new tax bases may be the preferred approach to increasing revenue if future revenue needs increased.

159. To understand this question, we propose to first consider areas of overlap and difference between our two main tax bases and the pros and cons of changes in the tax mix between these bases. We then propose to consider what bases, if any, it might make sense to add to New Zealand's current tax mix. Different legal bases for taxation may, from an economic perspective, tax the same factor. Therefore, it is important to understand what the differences and overlaps are between various potential bases to understand what bases it might be sensible to add.

Our approach to this topic

160. As discussed, Inland Revenue is proposing that the next LTIB focuses on considering what broad structure of the tax system would be most suitable for the future. We propose to look at the broad structure of the tax system by focusing on two elements: tax bases and income and consumption tax regimes.

161. Our aim is to enable open discussion on the challenges that our tax system faces and possible options to address these challenges.

162. We will approach this topic by undertaking four main pieces of work:

- Developing an analytical framework, including an economic framework to understand the effects of taxes on income and expenditure.
- Considering the pros and cons of alternative income tax regimes and enhancements to our current income tax regimes.
- Considering the literature on the design of alternative consumption tax regimes and approaches to low-income offsets to consumption tax rate increases.
- Considering the pros and cons of new tax bases.

163. These work areas will be used to assess options for New Zealand.

Analytical framework and economic effects of taxes on income and expenditure

164. The analytical framework will consider what the objectives of a good tax system should be. We will be considering tax incidence (who bears the burden of a tax), the economic costs that taxes can impose and approaches to assessing equity. Our aim is to articulate the principles to guide the design of a good and enduring tax structure for the future which is flexible enough to be an attractive structure for successive governments who may have a range of different revenue and distributional objectives.

165. We will also examine economic effects of our two main tax bases on income and expenditure and compare them to taxes on labour income only. We will discuss areas of overlap and difference between these bases and consider the pros and cons of having two main bases rather than just one. We will also discuss the arguments for differential rates of taxation on labour versus capital income, and the pros and cons of changes in the tax mix between these bases.

Income tax regimes

166. As noted above, there are trade-offs between revenue integrity, efficiency and equity in the design of the income tax regimes. Given potential future revenue needs, we should not assume that the tax system of the future will align entity and top personal rates. A key question is whether alternative design features in the income tax

system or alternative approaches to income taxation can better manage rate differentials between different forms of income.

167. On income tax regimes, we intend to understand:

- The comprehensiveness of our income tax and trade-offs in its design (such as between impacts on productivity and revenue integrity).
- Would changes to our current regimes better manage differentials in the tax rates applying to income earned in different ways and provide greater flexibility to meet changing revenue and distributional objectives if necessary?
- The pros and cons of alternative income tax regimes used in other countries. For example, Nordic countries use a dual income tax regime that taxes labour and capital income separately at different rates.

Consumption tax regimes

168. As noted, consumption taxes have become an important part of the tax mix globally, in part due to their ability to raise revenue.

169. However, VATs have less ability to meet progressivity goals than income taxes, which may limit their capacity to be used to address increased revenue needs. While many countries' VATs provide exemptions for various goods and services, this approach provides limited progressivity at a high cost in terms of foregone revenue. There is a literature that investigates the design of progressive consumption taxes, including how to increase progressivity within existing VAT design (for example by providing offsets for tax increases on the expenditure side of the government balance sheet). We intend to investigate this literature as part of this LTIB.

Additional tax bases

170. Future fiscal pressures mean that alternative tax bases are likely to be contemplated in the future. Further, there is a question as to what mix of tax bases should form the stable core structure of our tax system, which is relevant at current revenue levels.

171. Given this, we propose to focus a chapter of the LTIB on considering the pros and cons of adding new tax bases to our current mix. We will consider the pros and cons of taxes on payroll (including social security contributions), land, real property, wealth, inheritances or estates, turnover, and transactions, and what overlaps and differences there are in these bases versus our existing bases.

172. The focuses on tax bases and tax regimes are related. Fiscal pressures mean that it is desirable to create an opportunity for open discussion of the pros and cons of introducing additional tax bases versus raising rates on existing bases if future revenue needs substantially increase. However, to answer this question, we also need to understand if adjustments to the various regimes through which income and consumption is taxed would increase the flexibility of the system to raise more revenue through increasing rates on our existing bases.

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