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9 October 2024

Dear Sir/Madam,

Long-term insights briefing: Our tax system: Bases and regimes

CPA Australia welcomes the opportunity to comment on the consultation **Long-term insights briefing: Our tax system: Bases and regimes** (briefing paper).

CPA Australia represents the diverse interests of more than 173,000 members, including over 3,000 members in New Zealand, working in over 100 countries and regions supported by 19 offices around the world. We make this submission on behalf of our members and in the broader public interest.

The briefing paper on New Zealand's tax system presents an opportunity to assess the challenges and opportunities that will potentially shape the tax framework for decades to come. This submission addresses the key questions outlined in the paper. A summary of our responses are as follows:

Summary of key responses

- The environmental scan identifies key long-term challenges for the New Zealand tax system, in particular, the demographic shifts due to an ageing population. Other challenges that should be considered include lagging productivity growth, inflation and cost-of-living pressures, housing affordability, health care, debt levels, and the impacts of technological disruption.

- The current New Zealand tax system does not provide a genuinely broad-based and low-rate structure. Exclusions, such as a comprehensive capital gains tax (CGT) regime, continue to apply pressure on income and GST rates. Evaluating the recalibration of the tax mix could create opportunities to lower rates while maintaining a stable revenue stream, thereby better positioning New Zealand to address demographic shifts related to an ageing population and the rising costs of healthcare and pensions.

- Balancing a stable core structure in New Zealand's tax system with the necessary flexibility to adapt to changing revenue and distributional objectives is important, as it fosters economic confidence, business certainty and therefore compliance, yet requires careful management to avoid complexity and uncertainty. Consideration should be given also to comprehensive expenditure reviews as an alternative approach to address fiscal imbalances.

- Understanding the pros and cons of various income and consumption tax approaches is vital for designing a future tax system that balances economic growth, equity, and efficiency, as each structure presents unique benefits and challenges that must be carefully evaluated.

- The current income and consumption tax bases in New Zealand should be evaluated and incorporating alternative revenue sources should be assessed based on international experience and its merits and pitfalls in achieving its policy objectives in creating a more effective tax system to address the identified future challenges.

- Options for a future tax system should be explored and modelled that addresses both higher revenue needs and current levels, while also reviewing government expenditures and retirement income policies in parallel to adapt to demographic changes and fiscal pressures.

We also refer to CPA Australia's recent research paper, Towards Better Tax Policy and Tax Reform for consideration in your review.

On a final note, the briefing paper is a thoughtfully written document that manages to cover a wide range of important issues in a clear and accessible way, while remaining concise. We appreciate the opportunity to make a submission.

Please refer to the Appendix for our detailed responses to the questions. If you have any queries or would like to discuss further, please contact Jenny Wong, jenny.wong@cpaaustralia.com.au.

Yours sincerely,

Ram Subramanian
Interim Head of Policy and Advocacy

Rick Jones
Regional Head

Appendix

Responses to questions

Does the environmental scan identify the key challenges facing our tax system over the long term?

The environmental scan identifies several key challenges that the New Zealand tax system will face over the long term. In particular, the paper highlights challenges include demographic shifts, particularly an ageing population, which is expected to exert downward pressure on income tax revenue as a larger share of the population transitions into retirement. The consequence of this is the slowing down of New Zealand's economic growth and expenditure pressures from pension and health care costs.

There are also other challenges that New Zealand faces that should be taken into account in the context of this review:

- **Productivity:** New Zealand's productivity growth has lagged behind other developed economies, and this remains a significant concern. Without a significant improvement in productivity growth, New Zealand's tax system will continue to come under pressure. Productivity is important for sustaining long-term economic growth, and without improvements, the country's tax system will face increasing strain. Low productivity growth limits wage increases, stifles business profitability, and curtails government revenue.
- **Controlling inflation and cost of living:** Persistent inflation has resulted in a cost-of-living crisis. Rising prices for essential goods, housing, and services are putting increasing pressure on households
- **Housing affordability:** Housing affordability has emerged as one of the most significant social and economic challenges in New Zealand. The rapid increase in property prices over the past decade has put homeownership out of reach for many, especially younger generations.
- **Healthcare**: New Zealand faces significant fiscal challenges, particularly in manageing healthcare expenditure. New Zealand's healthcare system is facing critical issues of equity, accessibility and financial sustainability. Healthcare expenditure is set to rise as the population ages, placing increasing pressure on government resources.
- **Debt levels**: The cost of debt servicing is becoming a growing concern, particularly as interest rates rise and government borrowing increases. Treasury has flagged that structural deficits are expected for the foreseeable future, with some interpreting this as an indication that these deficits may become a permanent feature of the fiscal landscape.
- **Technological disruption:** Advancements in artificial intelligence (AI), is reshaping the future of work and labour productivity, posing significant challenges and opportunities for New Zealand tax system. As AI automates manual labour and the population ages, reliance on traditional tax bases like Pay As You Earn (PAYE) may decline, requiring a re-evaluation of how taxes are generated. The briefing paper briefly acknowledges the issues in paragraphs 132-135 stating the issues are mainly in relation to tax administration. The issues concerning technological disruption is beyond just tax administration. Shifts in the balance between labour and capital will need to be addressed to ensure the tax system remains fit for purpose. The rise of digital technologies also calls for a review of the rules around "permanent establishments," as remote work enables more employees to work offshore for New Zealand-based employers as well as the rise of AI driven businesses. We agree there is a need for a more in-depth examination of how technological disruption impacts the tax system including both the tax base and tax administration, which should be conducted in parrallel to deveopments at a global level.

This raises questions about the long-term sustainability of New Zealand's fiscal policy and its capacity to fund essential services without exacerbating public debt levels. It will be important to ensure New Zealand's tax system can support these looming deficits and the country's growing expenditure needs.

While we are not necessarily suggesting that the tax system should directly address these challenges, we believe it is essential to acknowledge their potential impacts. Solutions may lie within the tax system, outside it, or in a combination of both.

How well positioned is our current tax system to respond to these challenges?

The current New Zealand tax system has strengths and weaknesses in its ability to respond to the identified challenges.

On one hand, the system's reliance on income and consumption taxes provides a stable revenue stream. However, New Zealand's current tax system does not provide a genuinely broad-based and low-rate structure, which will continue to exert upward pressure on income tax rates. In addition, the flat rate structure to the GST may hinder its responsiveness to changing economic conditions and demographic trends.

Ageing population and retirement income policy

New Zealand's tax system relies heavily on taxes like the income tax and GST. This provides a stable revenue stream to fund public expenditures, including healthcare and public pensions (New Zealand Superannuation). As the population ages, healthcare and pension costs are projected to rise substantially. The current system, which relies on income tax and GST, may struggle to generate sufficient revenue to fund public pensions. New Zealand's tax system does not provide a genuinely broad-based and low-rate structure, as exclusions, such as a comprehensive CGT regime, continue to apply pressure on income tax rates.

The working-age population is shrinking relative to the growing retired population, which creates a tax revenue gap. Fewer working-age individuals will be paying income taxes while a larger number of retirees draw on pension benefits and healthcare services. There is merit in evaluating the recalibration of the tax mix to create opportunities to lower rates while maintaining a stable revenue stream. This could better position New Zealand to address demographic shifts related to an ageing population and the rising costs of healthcare and pensions.

Unlike many international countries (not limited to the OECD) that rely heavily on payroll taxes or social security contributions, New Zealand's tax system funds public pensions (New Zealand Superannuation) through general taxation. To some degree this simplifies the system. However, there is also a need to consider reforms in New Zealand's retirement income policy in parallel to any review of New Zealand's tax system to ensure it is fit for purpose to meet the economic and social challenges that lie ahead. For example, considerations can include making KiwiSaver compulsory; examining how superannuation contributions to funds should be taxed eg considering the Exempt-Exempt-Taxed or EET principle; increasing contributions progressively and introduce a new means tested New Zealand superannuation regime.

Productivity

In the face of an ageing population and increasing costs of superannuation and healthcare, the briefing paper identifies that productivity growth will be an important source of economic growth. New Zealand has a low level of labour productivity compared to the average OECD country.

As the population ages, the downward pressure on income tax revenue must be addressed to ensure the tax system does not act as a disincentive to encourageing higher participation rates among older workers and women.

In addition, a tax system that is compatible with investment in innovation, technology, and skills development, and measures to support entrepreneurship will be important for boosting productivity.

New Zealand's corporate tax rate, currently set at 28%, has become less competitive compared to those in other OECD countries, raising concerns about the potential negative impact on investment and economic growth. A widening gap between personal, corporate, and investment vehicles like portfolio investment entities (PIEs) creates opportunities for tax avoidance and inefficiencies within the tax system, undermining public trust and compliance.

It is important to recognise that the corporate tax rate effectively serves as little more than a withholding tax. Many shareholders ultimately face additional taxation at their marginal rates, which diminishes the impact of any corporate tax reductions. Consideration should be given to a more aligned tax structure that reduces discrepancies among these rates. By more closely harmonising the tax rates, New Zealand can enhance its attractiveness to both domestic and foreign investors, fostering a more conducive environment for economic growth.

International tax settings warrant increased attention in the context of New Zealand's tax reform, particularly given the country's ongoing challenges as a capital importer facing productivity issues and a shortage of capital. Attracting capital has been a persistent struggle for New Zealand, yet this critical issue receives only short mentions in the briefing paper. A more robust focus on international tax policies could enhance New Zealand's ability to compete for foreign investment.

Controlling inflation and cost of living

Tax adjustments (such as income tax bracket indexation or using the transfer system in a targeted way to reduce the net cost on essential goods and services for lower income households) can be ways to provide relief to households under pressure from inflation and rising costs.

We support the principle of indexing marginal tax rates to inflation and by not adopting this approach it places New Zealand among a minority of OECD countries. Indexation not only preserves the integrity of the tax system by preventing bracket creep but also better meets the principle of equity.

While concerns have been raised about potential inflationary impacts, we believe that significant increases in government expenditure are far more likely to provoke inflation than adjusting tax thresholds to account for rising costs of living.

Housing affordability & property

Whether housing affordability can be addressed through tax policy has been contentious in countries like Australia and there is a need for better evidence and modelling of the subsequent secondary impacts of any changes to the tax policy settings for housing. For example, considerations should include how the changes in the tax policy setting for housing impact investment in property, supply and rental prices.

Land supply and regulatory constraints are also factors at play that contribute to escalating housing costs. Reforming land use regulations, planning restrictions and providng better incentives to infrastructure financing to enhance the availability of land for development are also factors to consider in tackling the fundamental supply issues that drive housing unaffordability.

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?

In considering whether New Zealand should focus on maintaining a stable core structure of its tax system while allowing for flexibility to adapt to varying revenue and distributional objectives, it is essential to weigh the pros and cons of such an approach, as well as explore alternative solutions, for example instead of looking to opportunities to raise revenue, comprehensive expenditure review should be undertaken.

A stable core structure of the tax system is important for fostering economic confidence and ensuring predictable revenue streams. Stability in tax structures can provide taxpayer certainty and enhance compliance. A stable tax framework enables businesses to plan for the long term and make informed investment decisions. However, a stable tax system can also pose challenges particularly in responding to evolving challenges New Zealand faces and the shift in societal needs, and economic shocks. For instance, during economic downturns, a flexible tax system can allow for adjustments that provide necessary relief to taxpayers and stimulate economic activity. Different tax bases can yield varying impacts on economic growth and equity, and thus a comprehensive analysis is necessary to inform policy decisions.

On the other hand, the flexibility of the tax system can lead to complications such as increased complexity. Frequent changes to tax policies can create uncertainty for investment decisions, making it difficult for taxpayers to model future costs, returns, and overall financial outcomes. Thus, while flexibility can be beneficial, it must be balanced with the need for a stable core structure to avoid undermining public trust in the tax system.

While flexibility in the tax system is essential for adapting to changing revenue and distributional objectives, it is important that this does not undermine the stability and integrity of the core tax structure. The introduction of the 39% individual tax bracket demonstrates the risks of prioritising short-term flexibility without considering broader impacts on the tax system. The recent increase in individual tax rates contradicts the broad-base, low-rate principle and incentivises income sheltering behavior. To address this, integrity measures, such as adjusting the trustee income tax rate, were introduced. However, these changes created further complexity by introducing two rates for the same tax base, increasing administrative and compliance burdens, while generating relatively modest revenue..

Alternative solutions, such as conducting a comprehensive expenditure review should also be considered. Expenditure reviews can help identify inefficiencies and areas where public spending can be optimised. By focusing on the spending side of the equation, the government can avoid over-reliance on making frequent adjustments to the tax system to address fiscal imbalances. A comprehensive expenditure review that is undertaken regularly helps ensure that public funds are used effectively before resorting to adjustments to the tax system to raise revenue.

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?

Understanding the pros and cons of different approaches to income and consumption tax is essential for shaping a suitable future tax system. Different tax structures can have varying impacts on economic growth, equity, and efficiency. For instance, while income taxes may promote equity, heavy reliance on income taxes can also disincentivise work and investment, whereas consumption taxes, while less progressive, can encourage savings and investment.

Revisiting a proposal to introduce a CGT in New Zealand requires careful consideration of the lessons from the Tax Working Group (TWG) proposals in 2019[1], which were ultimately rejected due to concerns over fairness, complexity, and potential impacts on investment behaviour. The TWG's recommendations, particularly the proposed 33% marginal tax rate without inflation adjustments, were seen by many as overly punitive. The pros and cons of alternative approaches should be explored as part of this review, such as grandfathering rules so that the new rules apply to asset purchased after a specific date (such as Australia's pre and post CGT concept), incorporating inflation adjustments to tax only real gains, introducing exemptions or concessions for personal use assets or small businesses, and implementing roll-over relief for reinvested gains. Given the sensitivity surrounding this issue, ongoing dialogue with key stakeholders will be essential to fostering a constructive discussion on what a workable CGT could look like for New Zealand.

Evaluating the potential of land taxes and increasing the GST rate offers both opportunities and challenges. Pros include the efficiency of land taxes, as land is immobile and less likely to be affected by market distortions. Increasing GST could simplify the tax system and broaden the revenue base, especially as consumption patterns evolve. It could also mitigate some of the tension highlighted in the paper from the altering the interaction between the personal tax system and the taxation of entities. However, cons include concerns about equity—higher GST rates can disproportionately affect lower-income households, worsening inequality if not addressed properly.

The tax and transfer system could be adjusted to compensate low-income taxpayers through targeted offsets, ensuring that the tax system remains fair while encourageing economic growth. A comprehensive analysis of these trade-offs will be important, particularly in light of ongoing debates about tax reform and the potential introduction of new tax bases to address current and future challenges.

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?

The income tax system in New Zealand has been critiqued for its progressive nature, which, while aimed at equity, may inadvertently discourage higher earnings due to the disincentives created by higher marginal tax rates. The reliance on income taxes can disproportionately affect those with variable income streams, such as self-employed individuals or those in precarious employment situations, thereby raising concerns about fairness and stability.

Conversely, the consumption tax, primarily implemented through the GST, provides a more stable revenue source that is less sensitive to economic fluctuations. Consumption taxes tend to be less distortionary than income taxes, as they do not penalise savings and investment. However, they can be regressive, disproportionately impacting lower-income households who spend a larger share of their income on consumption. There has been recent

[1] New Zealand Government, Tax Working Group. *Future of Tax: Final Report*. Vol. I: Recommendations and Vol. II: Design Details of the Proposed Extension of Capital Gains Taxation, 21 Feb. 2019.

literature[2] on adjustments that can be made to ensure the GST is less regressive. While the IMF's suggestion of a progressive VAT is noted, we believe that the current system of transfer payments through the welfare system already plays an important role in addressing the regressive impacts of consumption taxes.

In New Zealand, the consideration of alternative revenue sources, including inheritance, estate and wealth taxes, must take into account the lessons learned from international experiences. For instance, while some European countries, have implemented wealth taxes, the overall success and sustainability of these measures remain contentious. The OECD's report on wealth taxation[3] outlines both the advantages and disadvantages of such taxes, suggesting that they may not be the panacea for fiscal challenges faced by governments. The effectiveness of wealth taxes can be undermined by tax avoidance strategies employed by high net wealth individuals, who can shift their assets to lower-tax jurisdictions. These issues were also highlighted in a recent OECD report on *Taxation and Inequality*[4] reporting on the declining reliance on revenues from inheritance and wealth taxes in OECD countries.

In addition, an American economist[5] recently noted that one of the biggest and often overlooked issues with a wealth tax is how it benefits foreigners at the expense of domestic investors. While local taxpayers would face higher taxes on unrealised capital gains, non-resident foreigners would remain largely exempt from these taxes. As a result, local investors would have a financial incentive to sell their assets to foreigners, lowering domestic ownership of productive capital. Over time, this would erode the wealth of local investors while increasing foreign ownership of key local assets. The risk of significant outmigration, particularly to Australia, is real and could be exacerbated if a wealth tax were introduced in New Zealand. It is also worth noting that economists (including French economist, Thomas Picketty)[6] acknowledge that wealth and inheritance taxes are only effective if systematic and consistent, both at a domestic and global level, requiring more intensive international coordination.

As noted above, expenditure reviews could assist in identifying inefficiencies in public spending and ensuring that tax revenues are utilised effectively. By focusing on how public funds are allocated, New Zealand could enhance the overall efficiency of its fiscal policy, potentially reducing the need for frequent tax adjustments and allowing for a more stable tax environment.

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?

The consideration of options for a future tax system that accommodates both higher revenue needs and current revenue levels is necessary but there also needs to be a review of government expenditures. As New Zealand faces increasing fiscal pressures, particularly from an ageing population and rising public expenditure demands, it is worthwhile modelling both incremental reform options to the existing tax structure and more radical changes that could fundamentally alter the tax landscape. By evaluating these options, the New Zealand IR can provide a roadmap for sustainable fiscal policy that meets the needs of future generations.

In addition, the adequacy of New Zealand's retirement income policy should be reviewed to ensure it addresses the challenges posed by an ageing population and ensuring that all citizens can enjoy a dignified retirement. Together with a review of the tax system, retirement income policy should be subject to regular reviews to adapt to changing demographics, economic conditions, and societal needs. This allows policymakers to identify emerging challenges and opportunities, ensuring that the retirement income framework remains relevant and effective.

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[2] Swistak, A., & de la Feria, R. (2024). Designing a Progressive VAT (IMF Working Paper). International Monetary Fund, April 5, 2024
[3] OECD 2018, *The Role and Design of Net Wealth Taxes in the OECD*. *OECD Tax Policy Studies, No.26.*
[4] OECD 2024, *Taxation and Inequality*: OECD Report to the G20 Finance Ministers and Central Bank Governors, OECD Publishing, Paris
[5] Cowen, Tyler. *Harris' Wealth Tax Would Mostly Benefit Foreigners*. Bloomberg Editorial, September 6, 2024
[6] Piketty, T., Saez, E., & Zucman, G. (2023). *Rethinking capital and wealth taxation*. Oxford Review of Economic Policy, 39(3), 575–591