The Treasury

Budget 2023 Tax Initiatives Information Release

July 2023

This document has been proactively released by the Treasury, Inland Revenue, Minister of Finance (Hon Grant Robertson) and Minister of Revenue (Hon David Parker) on the Treasury website at:

https://www.treasury.govt.nz/publications/information-release/budget-2023-tax-initiatives

Information Withheld

Some parts of this information release would not be appropriate to release and, if requested, would be withheld under the Official Information Act 1982 (the Act).

Where this is the case, the relevant sections of the Act that would apply have been identified.

Where information has been withheld, no public interest has been identified that would outweigh the reasons for withholding it.

Key to sections of the Act under which information has been withheld:

[33] 9(2)(f)(iv) - to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials

[34] 9(2)(g)(i) - to maintain the effective conduct of public affairs through the free and frank expression of opinions

[35] 9(2)(g)(ii) - to maintain the effective conduct of public affairs through protecting ministers, members of government organisations, officers and employees from improper pressure or harassment;

[36] 9(2)(h) - to maintain legal professional privilege

[38] 9(2)(j) - to enable the Crown to negotiate without disadvantage or prejudice

[39] 9(2)(k) - to prevent the disclosure of official information for improper gain or improper advantage

Where information has been withheld, a numbered reference to the applicable section of the Act has been made, as listed above. For example, a [33] appearing where information has been withheld in a release document refers to section 9(2)(f)(iv).

Copyright and Licensing

Accessibility

The Treasury can provide an alternate HTML version of this material if requested. Please cite this document's title or PDF file name when you email a request to information@treasury.govt.nz.

TE TAI ŌHANGA
THE TREASURY

Medium-term Revenue Strategy

Finance Priorities Meeting

19 July 2022

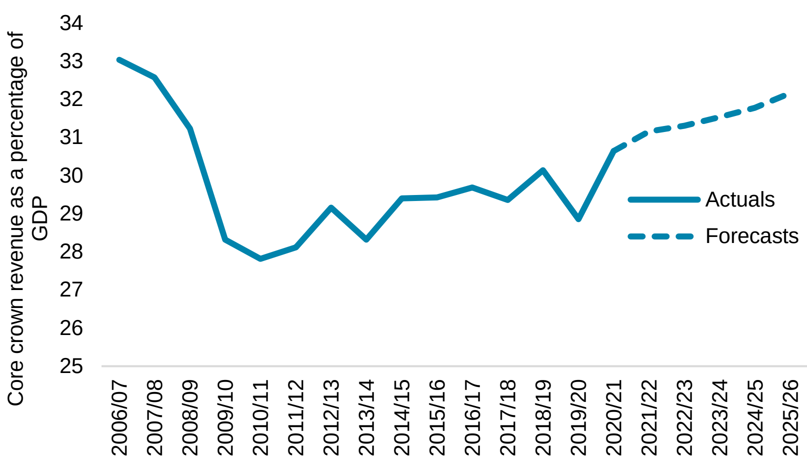
Context

Revenue since 2010 has grown by around 2% of GDP and has helped fund growing expenditure demands

The main cause of this revenue growth is fiscal drag

Other policy changes have also raised revenue (e.g. higher top personal tax rate and removing interest deductibility).

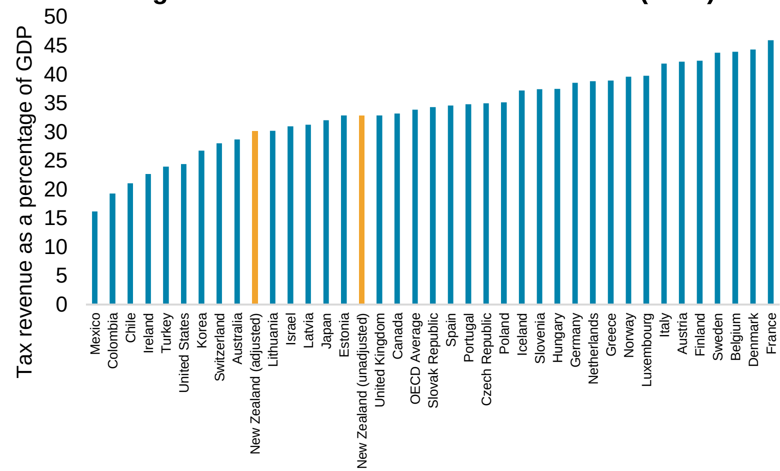
Figure 1. Core crown revenue as a percentage of GDP



New Zealand's tax revenue is still below the OECD average

And revenue in New Zealand has been higher in the past. For example in 2007 tax revenue was approximately 33% of GDP (compared with 30% now).

Figure 2. Tax to GDP in OECD countries (2018)



New Zealand (adjusted) removes the GST New Zealand applies to public services. We do this adjustment because New Zealand is unique in applying GST to public services which can make our tax to GDP ratio look artificially high relative to our international peers when using the standard OECD methodology.

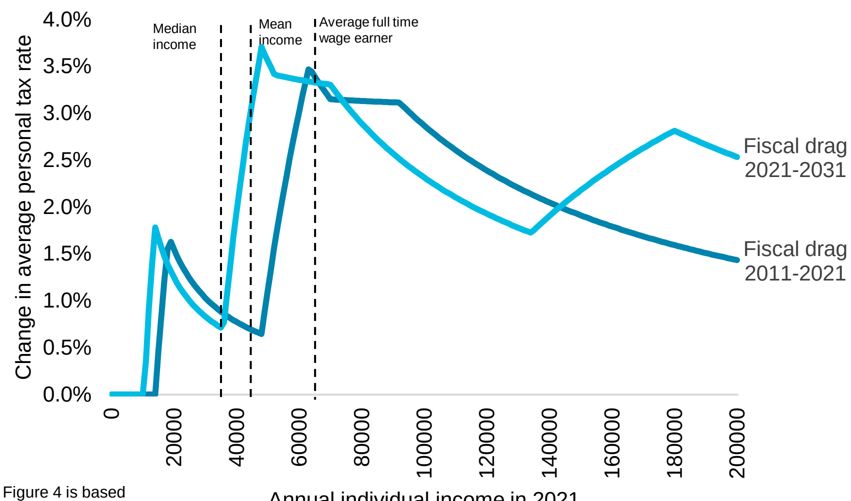
Revenue growth can help you meet your fiscal objectives

However, raising revenue is likely to create more trade-offs than it has in the past

Figure 3 shows how allowing fiscal drag to continue could help address fiscal pressures. However, this comes with trade-offs:

- **Distributional.** Figure 4 shows how fiscal drag has had the greatest impact on average full time wage earners. However, it is increasingly impacting lower income individuals over time
- **Economic.** The economic costs of raising revenue through fiscal drag are likely to increase over time. However, the economic costs are likely to be lower than many other options to raise similar amounts of revenue.
- **Integrity.** Fiscal drag will create more pressure on the integrity of our personal tax system

Figure 4. Increase in average tax rates due to fiscal drag



Note. Figure 4 is based on BPS 2021 forecasts

Figure 3. Total Crown operating balance before gains and losses (OBEGAL) as a proportion of GDP

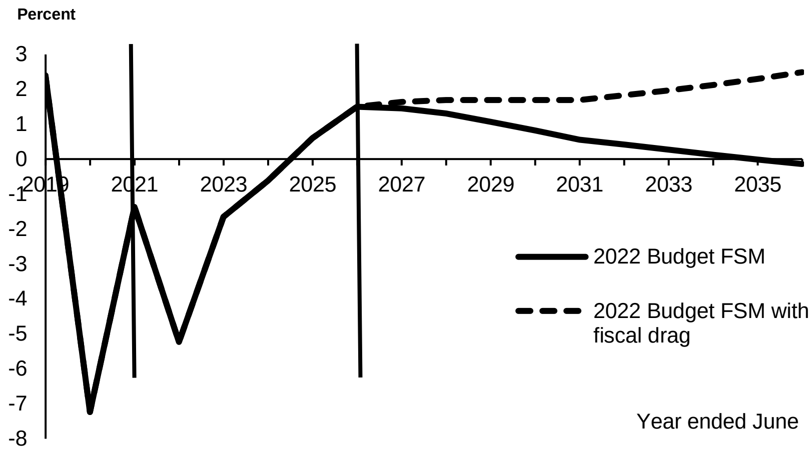


Figure 3 shows the projected OBEGAL position in Budget 2022 and also an alternative scenario where fiscal drag is allowed to continue over the projection period.

It illustrates how revenue policy could play a part in meeting your fiscal objectives.

Misalignment continues to be a challenge

What is misalignment?

Misalignment is where the company (28%), trustee (33%) and some passive income (PIEs, including managed funds and cash PIEs at 28%) tax rates are lower than the personal tax rates (up to 39%).

This is a longstanding issue, for example the company tax rate has been lower than personal tax rates since 2000.

These misaligned tax rates lead to high income individuals avoiding higher personal tax rates by diverting their income into these entities so their income is subject to lower tax rates (and this can occur even if they didn't structure this way for tax reasons).

Misalignment constrains our ability to raise revenue and creates costs for living standards

1. **Revenue** from personal tax is reduced as individuals avoid higher personal tax rates. This avoidance also constrains our ability to raise further revenue by raising personal tax rates.
2. Misalignment reduces **social cohesion** and the **progressivity of the tax system.** Inland Revenue and Treasury are doing further work on the distributional impact of these issues (high-wealth individual and effective tax rate research)
3. Misalignment creates **economic costs** as it creates arbitrary differences in how we tax income and encourages structuring to avoid tax

These pressures have been increasing and are likely to continue to grow over time

Since 2010, these pressures have been growing both due to policy changes and as fiscal drag has moved more income and people into personal tax rates that are higher than the company rate.

Internationally the gap between personal tax rates and company rates is also growing.

We recommend you explore options to achieve your revenue objectives

SHORT TERM – support year-on-year fiscal management

- A more strategic approach to ongoing revenue raising
  - Commission Inland Revenue and Treasury to explore a pipeline of revenue raising options
  - Improve alignment of tax policy and Budget processes

LONGER TERM – reviewing the revenue strategy

- Explore more fundamental reforms to the tax system including looking at :
  - How could the tax system be redesigned to address misalignment pressures?
  - How could the tax system help address fiscal challenges?
  - How could the tax system better meet your distributional objectives?
  - Are there revenue options that could support the economic strategy?

Short term: Revenue options to support year-on-year fiscal management

You could more closely align the tax policy work programme with your revenue strategy

Currently much of tax policy is managed outside of the Budget cycle

Most revenue raisers and revenue arise over the year through the Government's Tax and Social Policy work programme.

This means the tax policy priorities may not be aligned to your fiscal objectives

For example, options for revenue raising may not be progressed because there is no strategic direction to do so against other priorities.

This means that even if Ministers want to raise additional revenue to live within (or increase) allowances as part of the Budget process, there is a limited pipeline of options available to do so.

We suggest you explore options to align the work programme with your revenue strategy

1. ***Commissioning base broadening and revenue raising options***

This involves taking a more direct role in prioritising revenue raising as part of the work programme. There would inevitably be trade-offs with other elements of Inland Revenue's work programme.

2. ***Increased alignment of non-Scorecard tax policy and Budget process***

This would allow more consistent policy trade-offs and assessment of the need for revenue options and how revenue is used. There are practical constraints that are important to consider, e.g. bill and consultation timetables.

<u>Next steps</u>

We recommend you commission further advice from Treasury and Inland Revenue on revenue raising options and aligning tax policy with Budget processes. This commissioning could be done through a Joint Ministers meeting in August or September. Any further advice after this can then be used to inform the review of Tax Policy Work Programme (at which point Minister can judge its relative priority).

There is likely limited scope to raise significant revenue at Budget 2023. However, progress now could support allowance decisions at Budget 2024 onwards.

Medium term: Ensuring tax system is sustainable in the medium term

Our current ‘broad-base low rate’ tax system will likely need to evolve to meet your objectives

The revenue strategy faces challenges to meet four competing objectives

Revenue sufficiency and sustainability

- The tax system needs to raise sufficient revenue, consistent with your fiscal strategy and our revenue bases need to be sustainable over time.

Social cohesion

- We need to ensure that our tax system is considered fair and has integrity in order to maintain public confidence and maintain social cohesion.

Distributional objectives

- The tax system needs to meet your distributional objectives for progressivity, horizontal equity and reducing inequality.

Economic strategy

- The revenue strategy needs to align with your economic goals (high wage, low emissions, economic security).
  - This could include exploring tax reforms to support your economic strategy. However, these will often be revenue negative and may require packages of reform to align with your fiscal objectives.

Our current tax structure is likely insufficient to meet all four of these objectives in the medium term

This primarily arises because of the constraints caused by misalignment and the inconsistent way we tax otherwise identical taxable income.

There are three ways we could respond to medium-term pressures…

Maintain existing system but undertake broad-based increases to tax rates	Structural reform to our income tax base	New or expanded tax bases
This would maintain the existing misalignment problems but increase tax rates broadly to address fiscal pressures while minimising additional misalignment. E.g. Fiscal drag, or increasing all personal tax rates, GST or company tax. This can be done alongside targeted integrity measures to reduce the impact of misalignment. **These are likely to meet revenue and economic objectives, however, they will not address other objectives.** This option will not fully address misalignment and so would maintain pressure on social cohesion and may not meet your distributional objectives.	**This would take a more strategic look at the tax system, and look to address pressures of misalignment.** E.g. taxing companies at personal tax rate of their shareholders or reviewing the 'Nordic' approach to income taxation. **These could potentially meet all three of your objectives and would address misalignment pressures.** However, these are significant and complex reforms and would take significant time to investigate further.	**In addition to either of these approaches, we could explore new or significantly expanded tax bases.** For example, taxing capital gains, land, or greater use of corrective taxes and user charges. **These can potentially meet all three of your revenue, distributional and economic objectives.** However, all options face trade-offs and can be challenging to implement.

We will provide you with further advice on these medium-term pressures. This includes the role of the revenue strategy in the economic strategy.

If you want additional updates on the progress of this work we can provide this at Joint Ministers meetings.