NEW ZEALAND BUSINESS ROUNDTABLE

SUBMISSION ON THE

TAX REVIEW 2001 ISSUES PAPER

JULY 2001

EXECUTIVE SUMMARY

This submission is made by the New Zealand Business Roundtable (NZBR), an organisation comprising primarily chief executives of major New Zealand business firms. The purpose of the NZBR is to contribute to the development of sound public policies that reflect overall New Zealand interests.

The NZBR welcomes the opportunity to make this submission on the Issues Paper released by the Tax Review in June 2001.

We consider the Issues Paper is a high quality document that:

- sets out the principles that should guide tax policy development in a sound manner;

- clearly identifies the implications of applying those principles to the reform of the tax base, eco-taxation, tax rates, entity taxation, international tax and the tax treatment of savings; and

- provides interested parties with an opportunity to comment on the Review's preliminary thoughts on options for reform.

Direction of tax reform proposed by the Review

The NZBR endorses the broad direction of tax reform outlined by the Tax Review in its Issues Paper. In particular, we support the Review's:

- **endorsement of the general direction of tax reform** pursued by successive governments over the last 15 years, which has involved broadening the tax base and lowering tax rates;

- **conclusion that further reductions in tax rates are desirable for both**:

- **residents**. We welcome the Review's proposal to reduce tax rates for most residents through the introduction of a less progressive personal income tax scale that realigns the top personal and company tax rates. We agree with the Review that income redistribution is better pursued through direct expenditure rather than by increasing the progressivity of the personal tax scale. However, the case for income redistribution beyond the provision of a safety net is doubtful. We also support the Review's decision to retain the individual as the taxable unit (rather than assess tax on a family or household basis) and its view that the introduction of a 'tax-free threshold', a 'universal basic income' or a ‘universal child benefit' would not improve the tax system; and
- **non-resident investors in New Zealand.** We strongly support the Review's emphasis on making New Zealand a more attractive destination for internationally mobile capital through reductions in the effective rates of tax applying to foreign equity investment. We agree with the Review that this is best achieved through mechanisms other than just lowering the company tax rate;

• **cautious approach to the development and introduction of further base-broadening initiatives**. We agree with the Review's:

- rejection of the OECD's proposals to comprehensively tax capital gains and housing in New Zealand. We agree with the Review that the returns to owner-occupied housing in New Zealand should not be taxed unless a viable regime can be developed that can be shown to improve the fairness and efficiency of the tax system, does not involve unreasonable compliance costs and is capable of commanding public support;
- intention to consider the repeal of concessionary tax regimes (accelerated depreciation allowances and the immediate deductibility of capital expenditure on research and development, forestry, film production and petroleum mining) and their replacement with 'normal' income tax rules where practicable;

- support for the GST regime. As noted by the Review, the GST is more equitable than many believe;
- intention to consider the repeal of both gift and cheque duties;
- criticism of the arguments that have been advanced to date in support of the high rates of excise tax imposed on alcohol, fuel, gaming and tobacco;
- conclusion that cash flow taxes, financial transactions tax (including 'Tobin' taxes on foreign exchange transactions) and wealth taxes should not be adopted;

• **reservations regarding the desirability of eco-taxes**. We support the Review's view that:

  - there is no unilateral action that New Zealand can take that will make a measurable impact on greenhouse gas levels since it makes an insignificant contribution (0.2 percent) to global greenhouse gas emissions;
  - full compliance with the Kyoto Protocol, which seems highly improbable at this stage, would only have a minor impact on global warming;
  - the potentially profound sectoral and distributional effects of New Zealand's proposed approach to global warming have not been adequately identified by the analysis carried out to date;
  - the design, monitoring and compliance costs associated with a domestic emissions trading system are sure to be high; and
  - New Zealand should not introduce a carbon charge prior to its ratification of the Kyoto Protocol;

• **sensible approach to achieving a more consistent tax treatment of different entities**. We support the broad direction of reform proposed by the Review, which involves applying company tax treatment to widely held entities and partnership treatment to closely-held entities; and

- **opposition to the introduction of specific incentives for savings and other tax concessions**. Special tax concessions are unlikely to increase the overall level of saving and would reduce the quality of saving and investment decisions.

Preferred medium-term tax strategy

Consistent with the broad principles and general direction of reform outlined by the Review in its Issues Paper, the NZBR believes that, in the medium term, New Zealand governments should be seeking to:

- **Reduce government spending**. As discussed in section 4 of this submission, expenditure reform is a crucial prerequisite for further tax reform in New Zealand. The scope for broadening the tax base is too limited to raise the additional revenue required to fund significant reductions in rates of income tax, the repeal of remaining cheque duties and the phasing out of excise duties. The high and rising 'deadweight' costs of raising tax revenue mean that it is essential for the government to:

  – keep its expenditure decisions under constant review using the principles outlined in section 1 of this submission. Expenditure decisions need to be made with regard to the economic costs of raising the revenue required to finance that expenditure. Projects financed by tax revenue need to produce rates of return well in excess of normal business rates of return to cover the additional 'deadweight' costs of raising that tax revenue;

  – focus its attention on improving the quality of the core services provided, and discontinue expenditure on non-core services; and

  – establish a goal under the Fiscal Responsibility Act of reducing government spending to at least 30 percent of GDP over the next few years. This would be a useful first step towards lowering total government spending to around 20 percent of GDP in the medium to longer term.

- **Implement lower and more uniform tax rates for both residents and non-residents to make New Zealand 'stand out from the crowd'.** If the government is serious about attracting and retaining skilled labour and foreign investment and improving the quality of investment decisions, it is essential to implement significantly lower and more uniform rates of tax for both residents and non-residents. In particular, we believe it is important to:

  – reduce statutory rates of income tax applying to the worldwide income of residents to a maximum of 25 percent (as discussed in section 4 of this submission) and apply a cap to the total tax liabilities of individual taxpayers;

  – reduce the average effective rates of New Zealand tax on equity investment by non-residents to at least 15 percent. We believe the best approach to achieving such a reduction would be through a targeted reduction in the company tax rate applying to direct equity investment (to the extent that companies are owned by non-residents) and an increase in the foreign investor tax credit (FITC) on income from foreign portfolio equity investments (as discussed in section 5 of this submission); and

  – consider further the feasibility of improving the quality of residents' offshore investment decisions by repealing the grey list and replacing the controlled foreign company (CFC) and FIF regimes with the risk-free return method (RFRM) as proposed in option 2 of Chapter 6 of the Issues Paper (and discussed in section 5 of this submission).

- **Repeal concessionary tax regimes**. As proposed by the Review, the concessionary tax regimes (accelerated depreciation allowances and the immediate deductibility of capital expenditure on research and development, forestry, film production and petroleum mining) should be repealed and replaced with 'normal' tax rules where practicable.

- **Explore the scope for further broadening the tax base through the application of the RFRM**, as discussed in section 2 of this submission. However, we agree with the Review that it is too early to determine if such reforms would be desirable or feasible. The overall merits of the proposal need to be examined fully and carefully against recognised criteria. In addition, there are many issues regarding the design and potential effects of the RFRM that would need to be resolved. The best approach at this stage would be to address those issues in a separate discussion document. Similarly, we consider it would be useful to release a separate discussion document on entity taxation that would outline the implications of the Review's proposed approach in greater detail for public comment.

- **Remove remaining cheque duties and phase out excise duties**. Excise taxes and duties are an inefficient and inequitable way of raising revenue. We agree with the Review that a compelling argument for applying excise taxes to correct for perceived externalities has not been made. We are doubtful that it could. As a result, we support the Review's proposal to repeal remaining cheque duties and we believe the Review should outline a timetable for phasing out excise duties on alcohol, gaming, fuel and tobacco over, say, 5 years.

- **Review New Zealand's climate change policy in the light of the US government's decision not to ratify the Kyoto Protocol**. In particular, as discussed in section 3 of this submission, it is essential for the government to undertake a detailed analysis of the benefits and costs that New Zealand would incur if it were to introduce a carbon charge or a system of tradeable emission quotas.

- **Promote increased saving and investment through reductions in government spending and lower tax rates**. The best approach to encouraging saving and investment in New Zealand is for the government to reduce its expenditure on non-core activities and use the surplus revenue to fund further significant reductions in rates of income tax. By contrast, the provision of selective tax concessions to encourage saving and investment is unlikely to increase the overall level of saving in New Zealand. Rather, it is more likely to reduce the quality of saving and investment decisions.

- **Reduce tax compliance costs**. The costs of complying with the tax system are typically the largest compliance costs reported by businesses. The only effective way of reducing compliance costs is to move to lower and more uniform rates of tax.

- **Refocus local government on its core public good roles**, rather than give it a more expansive mandate. The property rating base is adequate for financing necessary local public good functions that cannot be financed from appropriate user charges. There should be no rating differential for commercial and industrial ratepayers.

As a matter of strategy, we believe the Review should devote most of its efforts in preparing its final report to augmenting the case it has made for reducing the economic costs of taxation through a lower government spending share of the economy and moves towards much lower rates of tax and a more uniform scale. We are not aware of any country that has achieved sustained growth in annual per capita incomes of 4 percent or more – the level of performance targeted by the prime minister and other political leaders – with a government sector accounting for 40 percent of the economy. This central issue, and the deadweight costs associated with high effective marginal rates, need to be highlighted. We also think the Review should concentrate on making judgments about international tax issues that have been in abeyance for far too long.

By contrast, we do not consider the Review should give priority to detailed elaboration of its ideas on taxing capital income and entity taxation in the limited reporting time available to it. These should be the subject of further analysis and consultation over a longer time period. A focus on such areas risks distracting attention from what in our view should be the core issues, a danger illustrated by the reaction to the discussion of the taxation of housing in the Issues Paper.

Finally, we believe there should be a sense of urgency in the Review's comments about tax policy. The government spending ratio and the overall tax burden in New Zealand have been rising in recent years, contrary to international trends. Well-performing countries like the United States and Ireland are cutting high tax rates on a systematic basis. As every year passes, New Zealand risks losing further ground with companies reacting to global trends in tax rates and to other pressures of globalisation, and as entrepreneurial people take advantage of opportunities offered by more favourable fiscal climates. To really 'stand out from the crowd' and succeed in the face of these trends, New Zealand in our view needs to implement major and urgent changes in the direction of its tax policy.

1 FRAMEWORKS FOR TAX POLICY

Principles

An important function of the Review is to establish a framework of principles to guide tax policy development through all phases of the generic tax policy process (GTPP). As noted by the Review, such a framework is required to avoid ad hoc policy changes that lead to low quality policy and create instability and uncertainty.

In particular, as discussed in sections 1.1.1 and 2 of our first submission, the Review needs to identify broad principles that will help the government to:

- **determine the role that the tax system should play in achieving its economic and social policy objectives** (eg to resolve key tax policy issues such as the amount of revenue that should be raised via the tax system as opposed to user charges and debt, and the extent to which the tax system should be used to redistribute income and encourage or discourage certain activities. These are the key types of tax policy issues that arise during the 'strategic' phase of the GTPP when the government is in the process of determining its economic and fiscal strategies); and

- **review and reform the current tax system** to improve its ability to perform that role (eg to identify deficiencies in the design of the current tax system and identify, evaluate and develop alternative options for reform. These are the key tax policy issues that arise in the 'tactical', 'operational' and 'implementation and review' phases of the GTPP).

The Issues Paper summarises the principles of 'equity' and 'efficiency' that should be applied by government in reviewing and reforming the tax system. In particular, it highlights:

- the inherently subjective nature of concepts of 'equity' and the need to consider the economic incidence of taxes rather than just their legal incidence;

- the high and increasing 'deadweight' costs of taxation and the consequent need to keep tax rates as low and as uniform as possible and the tax base as broad as possible; and

- the practical limits to making the tax system fairer and more efficient, which include the inability to tax the returns from certain activities and the increasing economic integration of the New Zealand economy with the rest of the world. As noted by the Review, although this integration brings with it significant benefits, the greater mobility of skilled labour and financial capital means that the costs of taxation are higher than they previously were for a given rate of tax.

However, it is more difficult to locate a clear statement of the principles that should be applied by the government when it is determining the appropriate role that the tax system should play in raising and redistributing revenue, and encouraging or discouraging certain activities.

There is a brief discussion of the last set of issues in paragraphs 48 to 57 of Chapter 1. In particular, the Review notes that, as a general principle, there should be a strong presumption against extending concessionary treatment to any particular activity or sector.

By contrast, there is little discussion of the principles that should be applied by the government when determining the role that the tax system should play in raising revenue. This needs to be remedied in the final report. As discussed in section 2.1.2 of our first submission, those principles are well established and form the basis of the Regulatory Impact Statements (RISs) that must accompany proposals for regulatory reform to Cabinet. Specifically, before deciding to use the tax system, or any other policy instrument, to intervene in the market, governments need to:

- determine the nature and extent of the problem and establish that there is a case for intervention;

- clearly define the objectives of the proposed intervention, so that it is possible to monitor and review its effectiveness;

- identify and evaluate alternative policy instruments; and

- establish that the proposed intervention will produce net benefits for New Zealand.

Institutional framework

In addition to an appropriate set of principles, it is important to have an appropriate institutional framework within which those principles can be applied in a consistent manner.

We agree with the Review that although the GTPP has improved the process of tax policy development, it has not delivered as much as it could. To date, most attention has focused on the operational and legislative phases of the process. As a result, the process of detailed tax policy design is now much more transparent and there is significant public consultation. However, as noted by the Review, there is still significant scope for improving transparency and the extent of public consultation during the strategic and tactical phases of the GTPP. At the moment, key tax policy decisions concerning the role of the tax system in achieving the government's fiscal, social, and broader economic policy objectives are still being made 'behind closed doors' and, contrary to the original objectives of the GTPP, there is little scope for input from external parties. The increase in the top personal tax rate in 2000 was a case in point.

We believe the Review could assist in this regard by recommending that the government should:

- formally endorse the GTPP. This could be achieved either via the release of a statement of the government's commitment to the responsible development of tax policy (similar to the 'Government of Canada Regulatory Policy 1999'), or via the introduction of legislation (similar to the concept of a 'Regulatory Responsibility Act' that has been proposed for New Zealand). In either case, the government would provide a detailed outline of the processes and principles that it is committed to applying when it is developing tax policy. A discussion of initiatives on these lines to improve the process of policy development in New Zealand is contained in the independent review of New Zealand's Regulatory Impact Statement regime that was released recently by the Ministry for Economic Development under the Official Information Act; and

- publicly release a detailed 'tax strategy' statement at least every three years that:
  - identifies the government's economic and social policy objectives;
  - explains the role that the tax system is expected to play in achieving those objectives and the reasons it is the preferred policy instrument to achieve them. In particular, it is important to explain the role the tax system will play in raising revenue (ie the government's 'revenue strategy'), redistributing revenue to meet the government's social policy objectives, and encouraging or discouraging specific activities to achieve the government's broader economic, social and environmental policy objectives;
  - outlines the government's three year tax policy work programme (ie the proposed tax policy initiatives and the timetable for their development and implementation); and
  - reports on the extent to which the tax system, and the programme of tax reform, is achieving its intended objectives. The Review's proposal to require governments to publish a 'tax expenditure statement' would make the fiscal costs of tax concessions more transparent. However, it is also important to provide available estimates of the 'deadweight' costs of taxation, including administrative and compliance costs.

We agree with the Review that there is a need for more independent analysis not only of the government's 'tax strategy' but also the tax policies announced by opposition parties. As noted by the Review, potential sources of independent policy advice include universities, parliamentary committees and independent policy institutes. We do not, however, think that additional government spending should be incurred or that new government agencies should be established for this purpose.

2 TAX BASES

Income tax

As noted by the Review, although New Zealand's income tax base has been broadened significantly over the last two decades, there are still several significant 'gaps'. These include the concessionary income tax regimes currently applying to specific sectors of the economy and the absence of income tax on certain capital gains and imputed rental income from owner-occupied housing.

Sector-specific regimes (including research and development)

As discussed in section 3.2.2 of our first submission, there are several concessionary, sector-specific, tax regimes that encourage inefficient patterns of investment and resource use. Those regimes provide certain activities with tax concessions via accelerated depreciation allowances and immediate deductions for 'capital' expenditure incurred in research and development, forestry, film production, and petroleum mining.

We strongly support the Review's decision to consider the case for repealing concessionary regimes and replacing them with 'normal' income tax rules where practicable. However, we stress the importance of outlining any proposed changes to those regimes in a public discussion document to allow more detailed consideration of the feasibility of the specific changes involved.

Capital gains and housing

We also support the Review's rejection of the OECD's recommended approach to the taxation of capital gains and housing. As discussed in section 4.1.3 of our first submission, the introduction of a comprehensive capital gains tax on the sale of all shares and real property is unlikely to improve the overall efficiency of the tax system. In addition, as noted by the Review, there are major problems with the OECD's proposed approach to taxing housing in New Zealand. Taxing capital gains on the sale of houses would lock people into their current housing, impeding labour market mobility and placing a greater tax burden on those workers who have to move to another region to find employment. In addition, the provision of tax deductions for interest and other related expenses would introduce an even greater tax concession for owner-occupied housing.

Having rejected the comprehensive taxation of realised capital gains, the Review has identified two other potential approaches to reform:

- a continuation of the current 'pragmatic' approach of piecemeal reforms to the taxation of income from capital as problems arise; or

- a more radical approach of using a risk-free return method (RFRM) for taxing income from capital.

Similarly, having rejected the OECD's approach to taxing housing, the Review has suggested the possible use of the RFRM.

We see merit in exploring all of the options for reform outlined above in greater detail. In particular, the RFRM warrants further analysis and development since it appears to offer a means of overcoming some of the problems that arise due to the less than comprehensive taxation of income from capital while avoiding the problems associated with taxing capital gains on realisation. For example, the RFRM would not distort the choice between shares that produce income in the form of dividends as opposed to capital gains and it would remove the incentive to recharacterise taxable income as non-taxable 'capital gains'. In addition, it would provide an effective means of indexing income from capital for the effects of inflation.

However, we agree with the Review that it is too early to determine whether it would be desirable or feasible to implement an RFRM. Introduction of the RFRM would involve a fundamental shift in how New Zealand taxes income from capital and there are numerous issues concerning the design and likely effects of such a regime that need to be resolved before a decision can be reached on the feasibility of the approach. We believe those issues are best addressed in the context of a separate discussion document on the RFRM. Our views on some of those issues are outlined briefly below.

Scope of the RFRM

A key issue in the design of the RFRM, which also influences the likely effects of the regime, is its scope. In theory, the RFRM could be applied to measure the income that taxpayers are presumed to derive from all of their investments. The Issues Paper outlines a number of alternative options. Chapter 2 of the Issues Paper outlines proposals to apply the RFRM to certain capital gains and the income from housing. However, Chapter 6 also contains proposals to extend the RFRM to residents' foreign listed investments and foreign retail unit trusts (option 1), to all offshore equity investments (option 2), or to both New Zealand listed investments and all offshore equity investments (option 3).

In practice, the scope of the RFRM is constrained by its need for accurate annual information on asset values and the value of any outstanding debt that has been used to finance the purchase of those assets. In many respects, the RFRM is just as informationally demanding as a 'full accruals' approach to the measurement of income from capital and interest expense. This means that it is unlikely to be feasible to use the RFRM to measure the income that taxpayers are presumed to derive from all of their investments. Rather, it is more likely that:

- the scope of the RFRM would have to be confined to the measurement of the presumed income from those assets for which independently verifiable 'arms length' values are available each year (eg shares in publicly listed companies that are traded regularly in large volumes); and

- taxpayers would continue to be taxed on the 'actual' income they derive from their other investments.

This potentially limited scope of the RFRM regime has two important implications that need to be explored in more detail by the Review.

First, it is inevitable that taxing the inflation-adjusted 'presumed' income from some investments and the 'actual' nominal (ie non inflation-adjusted) income from other substitutable investments would distort patterns of investment to some extent. In order to reduce those distortions, it would be necessary to avoid taxing the presumptive income from certain investments while taxing the actual income from highly substitutable income. For example, as noted by the Review, if the RFRM were applied to owner-occupied housing it would also be desirable to extend it to rental housing.

Second, many of the investments that would be suited to the application of the RFRM are either already subject to accrual tax regimes (eg financial arrangements which are currently subject to the accrual rules, and the offshore investments of residents that are subject to the CFC and FIF regimes), or potentially suited to the application of accrual tax regimes. This raises the issue as to whether it is desirable to either:

- replace these existing accrual tax regimes with the RFRM (eg replace both the accrual rules and the CFC and FIF regimes with the RFRM); or

- extend accrual tax treatment to the actual income that taxpayers derive from certain equity investments (eg publicly listed shares). It would be useful for the Review to explain the reasons why such an approach is not favoured (eg the greater complexity involved in adjusting for the effects of inflation).

Liquidity concerns

Another key issue which needs to be examined in greater detail is the impact that the introduction of the RFRM would have on the liquidity of taxpayers.

Implementation of the RFRM would involve a fundamental change in the way in which New Zealand taxes income from capital. Whereas the current income tax regime seeks to tax the 'actual' net income that individuals derive from their investments, the RFRM would be seeking to tax the net income those individuals are 'presumed' to derive from them. Specifically, the RFRM would presume that all individuals derive an inflation-adjusted, risk-free rate of return regardless of the actual net income they derive each year from those investments.

The RFRM is attractive from the government's perspective since it is capable of providing a less volatile, and hence less risky, source of tax revenue. Under the current 'actual' income tax regime, the government in effect is a shareholder in all investments undertaken by taxpayers. If the investment produces a profit, the government shares in that profit, whereas if the investment produces a loss, the government shares in that loss to some extent by allowing it to be offset against future income tax liabilities. By contrast, under the RFRM the government in effect is more like a debt investor. Taxpayers have to pay a certain amount of tax to the government regardless of the profitability of their investment.

From a taxpayer's perspective, however, the RFRM has the undesirable effect of increasing the volatility of the returns from their investments and hence subjecting them to greater risk. Taxpayers who earn actual rates of return on their investments in excess of the presumed risk-free rate of return would have to pay less tax under the RFRM. By contrast, where a taxpayer makes a loss on an investment, the size of that loss is increased by the requirement to pay the risk-free rate of return on the investment to the government.

As a result, it is inevitable that situations will arise where the annual tax liability under the RFRM will exceed the cash flow the taxpayer derives from the asset in that year. This has the potential to cause liquidity problems, particularly for:

- new investments that involve large initial fixed costs and deferred cash inflows (eg new investments in forestry and infrastructure);
- new firms that are developing new products and processes;
- firms that are in the process of restructuring; and
- firms that are of doubtful viability or are in the process of winding up.

As noted by the Review, such liquidity problems are likely to cause genuine hardship in those cases where the RFRM is applied to lumpy investments that are not readily divisible and marketable (eg owner-occupied housing). Further consideration needs to be given to the design of possible options for relieving cases of genuine hardship.

Regardless of the position the Review finally takes on the RFRM option, we believe it should stress the desirability in any case of reducing high marginal tax rates to reduce the distortions arising from the non-taxation of certain investments such as housing.

Duties and Excise Taxes

The NZBR agrees with the Review that it is desirable to repeal remaining cheque duties and to consider the removal of gift duty. Any potential problems created by the removal of gift duty are better dealt with through the implementation of lower and more uniform rates of tax.

In addition, we commend the Review for its principled assessment of existing excise taxes. We agree with the Review that:

- it is difficult to justify excise taxes on 'efficient taxation' grounds;

- a particularly disturbing aspect of alcohol and gambling excises is their disproportionately severe impact on the minority of individuals and families who experience drinking or gambling problems;

- although the demand for gaming is sometimes estimated to be price elastic in aggregate, demand among problem and pathological gamblers can be expected to be highly inelastic. For problem gamblers, gambling expenditure, and its associated problems, can be expected to rise as taxes are raised; and

- targeted intervention, as opposed to excise taxes, is the preferred approach to dealing with most externalities that arise from the misuse of affected products. As noted by the Review, excises taxes are, of necessity, uniform across units of consumption of taxed commodities. External damage, on the other hand, will typically not be 'uniformly-mixed'. This places the tax system at the opposite end of the spectrum to targeted intervention such as regulation, or fines and sentences imposed through the Courts, which are capable of being closely calibrated to the source and the degree of harm.

In view of the inefficiency and inequities associated with excise taxation, we believe the Review should:

- recommend that excises and duties should be phased out; and

- outline a timetable for those phased reductions over, say, 5 years.

Tax mix

The Review identified the implications of the 'deadweight' costs of taxation for the tax mix. As noted by the Review, the GST regime is a potentially more efficient source of revenue than the current income tax regime. As a result, the Review has suggested that:

- if the government finds itself in a position to reduce taxes, it should first look to reduce rates of income tax rather than the rate of GST, since GST tends to be a somewhat more efficient source of revenue; and

- if the government has to raise tax revenue, it should consider raising the rate of GST first.

However, it is also important for the Review to outline the implications that the high and rising costs of raising tax revenue have for the government's 'revenue strategy'. As discussed in section 4 of this submission, those increasing costs mean that governments need to:

- keep their expenditure decisions under constant review. Projects financed by tax revenue not only need to be able to generate a 'normal' business rate of return, but they also need to generate an additional return that is more than sufficient to offset the 'deadweight' costs of raising that revenue; and

- consider other alternative sources of finance, such as user charges, or revenue saved by discontinuing government involvement in non-core activities.

Rather than raising the rate of GST, reductions in rates of income and excise tax should be funded by reducing government spending on non-core activities that do not produce rates of return sufficiently high to offset the economic costs of raising that revenue.

3 ECO-TAXES

The government has asked the Review to consider the role that the tax system should play in achieving its environmental policy objectives. In particular, the Review has been asked to consider the merits of using environmental taxes ('eco-taxes') as a means of correcting for perceived market failures arising from environmental externalities.

In order to examine this issue, the Review in effect has applied the broad principles outlined in section 1 of this submission. That is, the Review has sought to:

- determine the nature and extent of the perceived problem that may warrant government intervention; and

- identify and evaluate alternative options for addressing those problems including taxes, regulations, and tradeable quotas.

We agree with the Review that:

> 30 … the appropriate burden of proof on those advocating eco-taxes should be identical to the burden placed on those seeking concessionary tax treatment for particular activities or sectors. And as we explained in Chapter One, *Frameworks*, we consider the initial presumption should always be against the introduction of selective taxes.

The tax system should not be used to correct for perceived market failure arising from environmental externalities unless it can be established that:

- the existence of those environmental externalities is causing the market to fail to operate efficiently and is imposing a net cost on New Zealand;

- eco-taxes are the best available instrument at the government's disposal to correct for that market failure; and

- the imposition of those eco-taxes would produce a net benefit for New Zealand.

Unfortunately, New Zealand's current climate change policy, which involves ratifying the Kyoto Protocol and potentially implementing both a carbon charge and a system of tradeable emission permits, has not been developed in accordance with the broad principles outlined above. Consequently, the policy scores poorly when it is evaluated using those principles.

As noted by the Review, the science of global warming remains poorly understood, the relationship between carbon dioxide levels and temperature remains uncertain, and it is far from clear that any forecast increases in temperature would impose a net cost on New Zealand:

> 34 In addition to the uncertainty about whether a significant increase in average temperature will eventuate, the effects of such an increase are extremely uncertain. The temperature effects would not be spread evenly over the globe and it is thought that the temperature effects in the Southern Hemisphere (where oceans predominate) will be less than the global average. Independently of global temperature trends, increasing carbon dioxide concentrations are predicted to stimulate plant growth (carbon uptake by photosynthesis). This should benefit New Zealand.

This uncertainty is confirmed in a recent report released by the Ministry for the Environment, *Climate Change Impacts on New Zealand*, which concludes that:

> We are not in a position yet to estimate whether climate change might bring a net cost or benefit to New Zealand in the near future, and at what specific point the positive impacts could turn negative.

By contrast, it is clear that the introduction of either a carbon charge or system of tradeable emission permits would impose significant costs on New Zealand. As noted by the Review:

> 47 It is likely that the broad approach to which New Zealand governments have committed will have profound sectoral impacts. These sectoral

> and distributional effects are not adequately identified by the analytical studies carried out to date.

In addition, even if greenhouse gas emissions were causing global warming and imposing a net cost on New Zealand, it is far from clear that New Zealand can make any significant contribution to reducing the extent of that warming. As noted by the Review:

> 38 It would appear that full compliance with Kyoto will only have a minor impact on global warming trends. Further increases in atmospheric greenhouse concentrations are unavoidable and there is no unilateral action that New Zealand can take that will make a measurable impact on greenhouse gas level trends since New Zealand makes an insignificant contribution (0.2 percent) to global greenhouse gas emissions.

Indeed, it is far from clear that the costs of using a carbon tax and an emissions trading regime to abate emissions of greenhouse gases are less than the costs that New Zealand would incur from adjusting to the forecast climate changes.

In summary, the Review's evaluation raises serious doubts about whether New Zealand's current climate change policy would be of net benefit to the nation.

The Review's conclusion that it would not be desirable for New Zealand to introduce a carbon charge prior to its proposed ratification of the Kyoto Protocol is a step in the right direction but it does not reflect fully the Review's analysis, which suggests that carbon taxes are undesirable. As discussed further in section 4.2.4 of our first submission, we believe that the development of New Zealand's global warming strategy provides a good example of how easily 'government failure' can occur when governments do not apply the broad principles outlined in section 1 of this submission. Although the government appears to have committed New Zealand to ratify the Kyoto Protocol and to the possibility of introducing a carbon charge and tradeable emission quotas, it has yet to establish that New Zealand would derive a net benefit from the implementation of those initiatives. On the contrary, all available evidence points to their imposing a significant net cost on the nation.

The focus on global warming has diverted attention and resources from efficiency-enhancing initiatives that have greater potential to improve the environment in New Zealand. Obvious examples include roading reform to alleviate traffic congestion in Auckland, greater application of user charges for household waste collection and disposal, and reform of the dairy industry to eliminate the current incentives to over-production of milk.

We urge the Review to encourage the government to undertake a comprehensive review of New Zealand's climate change policies using the broad principles outlined in section 1 of this submission. Such a review is essential given the recent decision of the United States not to ratify the Kyoto Protocol and the absence of any detailed analysis to date of the likely benefits and costs of New Zealand implementing a carbon charge or tradeable emission quotas.

4 TAX RATES

Personal and company tax rates

The NZBR agrees with the Review that:

- a proportional (flat) tax scale has significant benefits over the current progressive one in terms of efficiency, administrative costs and reducing incentives to split income;

- the justification for a progressive tax scale on grounds of fairness is weak;[1]

- the high marginal tax rates at the top end of the income distribution discourage education and training and encourage emigration. The top income group does almost all the saving in New Zealand, and saving appears to be a residual that changes with fluctuations in income while consumption remains relatively constant. People in the top income group are likely to respond to

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1 See Cathy Buchanan and Peter Hartley, (2000), *Equity as a Social Goal*, New Zealand Business Roundtable, Wellington, pp 170-188, and Richard Epstein (forthcoming), 'Can Anyone Beat the Flat Tax?', *Journal of Social Philosophy and Policy*.

increases in tax rates by reducing saving, pushing the tax on to others by raising the prices of their services and increasing their efforts at avoidance;

- the current progressive personal income tax scale does not in fact redistribute income substantially more than would a proportional (flat) tax scale. Most redistribution of income occurs through government expenditure on benefits, education and health; and

- the limitations and costs of tax progressivity mean that increases in redistribution are best achieved through government spending, rather than by a progressive personal tax scale.

As a result, we support the Review's proposals to implement a less progressive personal tax scale and to realign the top personal and company tax rates. However, we are concerned that the illustrative 'fiscally neutral' tax scales outlined in Table 4.3 of the Issues Paper still involve:

- a significant gap of around 11 to 17 percentage points between the lowest and highest personal tax rates; and

- a top personal and company rate of around 31 to 34 percent, which is certainly not low enough to make New Zealand 'stand out from the crowd'.

At best, such 'revenue neutral' rate reductions should be viewed as a first step towards much lower rates of tax in the medium term. If New Zealand really wants to 'stand out from the crowd' it should be aiming to reduce personal and company tax rates to a maximum of 25 percent in the medium term. This would send a clear message that New Zealand is committed to encouraging wealth creation, education and training, retaining its skilled workforce, and increasing private saving and investment.

Table 4.4 of the Issues Paper illustrates the likely revenue costs of more significant reductions in personal and company tax rates. For example, at a cost of around $650 million to $750 million, it would be possible to implement a two step rate structure of 20 percent for income up to $29,500 and a 28 percent top personal and company rate.

This raises the issue as to how government can raise the additional revenue required to fund a significant reduction in tax rates.

Need for expenditure reform

In the past, governments have been able to simultaneously reduce tax rates and increase tax revenue through the introduction of significant base-broadening initiatives (eg the introduction of GST). As a result, there is now much less scope to raise additional tax revenue by broadening the tax base than there was in the past. As noted by the Review, if housing were taxed using the risk-free rate of return method, an additional $750 million of revenue could be raised. In addition, the Review's proposals to replace the concessionary sector-specific tax regimes with normal tax treatment would also raise additional revenue. However, it is far from clear that those initiatives would raise sufficient additional revenue to allow both a significant reduction in personal and company tax rates, the removal of remaining cheque duties, and the phasing out of excise duties.

As a result, we believe a sustained programme of expenditure reform is a top priority and is a crucial prerequisite for further tax reform in New Zealand. Significant reductions in tax rates are unlikely to be feasible in the medium term in the absence of such expenditure reform.

Although the Review is constrained by its terms of reference to consider only revenue-neutral packages of reforms to the tax system, governments clearly have the option in the future of funding further reductions in tax rates via expenditure reform. Indeed, in view of the high and rising 'deadweight' costs of raising tax revenue, it is essential for governments not only to review and reform the tax system to lower the costs of raising revenue, but also to review their expenditure decisions. Responsible governments should ensure that their expenditure decisions are made with regard for the economic costs of raising the revenue required to finance that expenditure and its benefits.

This requires governments to consistently apply the principles outlined in section 1 of this submission during the strategic phase of the GTPP when it is in the process of determining its role in the economy and the roles of its various policy instruments, including the tax system. In particular, when it is in the process of developing its revenue strategy (ie determining the role of the tax system in raising revenue), the government needs to ensure that:

- projects financed from tax revenue generate rates of return that are well in excess of normal business rates of return to cover the additional 'deadweight' costs of raising that tax revenue; and

- alternative and potentially more efficient methods of financing government expenditure are considered, such as government charges.

Consistent application of those principles would ensure that governments:

- focus their attention on the provision of core services such as the provision or funding of essential public goods and a social safety net; and

- discontinue expenditure on non-core activities.

We believe such an approach would enable the government to reduce spending over time to below 20 percent of GDP, increase the quality of the core services it provides and significantly reduce tax rates. As a first step towards achieving this objective, the government could:

- establish a goal under the Fiscal Responsibility Act to reduce central government spending to at least 30 percent of GDP over the next few years; and

- gradually reduce spending through a combination of specific expenditure reforms and by holding the rate of growth of government spending below the growth rate of the economy.

A forthcoming NZBR study estimates that, given the current extent of deadweight costs, a reduction in total government spending from around its present level of 40 percent of GDP to a level of 30 percent could be expected to add about 0.5 percentage points to the rate of growth of GDP over about a decade. This is a conservative estimate because it does not include the dynamic benefits of reducing the size of government. An econometric analysis that allows for dynamic effects suggests that a reduction in government spending of this order would add about 0.6 percentage points to the annual growth rate for 15 to 25 years. In addition to these transitional effects, there are good reasons to expect that smaller government would result in an ongoing improvement in New Zealand's economic growth performance. A copy of the executive summary of this study is attached to this submission.[2]

5 INTERNATIONAL TAX

Taxation of income earned in New Zealand by non-residents

The NZBR agrees with the Review that there are advantages to be gained from reducing the average effective tax rate that New Zealand imposes on the income that non-residents derive from their direct investment in New Zealand to at least 15 percent. Such a move would send a strong signal to foreign investors that New Zealand values their long-term commitment and would improve the quality of foreign investment in New Zealand by reducing the disparity in effective tax rates between debt and equity investments.

As noted by the Review, the main issue to be resolved before proceeding with such a reduction is whether it would benefit New Zealand. The possibility of taxing rents earned by foreign investors has been advanced by the Review as a possible reason for continuing to tax non-resident investors. Temporary rents are a normal and necessary feature of economic processes but are competed away in open markets. In the international tax context we doubt whether it is desirable or feasible to tax such rents without imposing significant efficiency costs. We note that the RFRM would not tax any rents.

Once the Review has verified that there are significant net benefits to be derived from a reduction in tax rates for non-resident investors, the next issue is to determine how best to achieve that reduction. We believe the best approach is via:

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2 Winton Bates (2001), *How Much Government? The Effects of High Government Spending on Economic Performance*, New Zealand Business Roundtable, Wellington.

- a targeted reduction in the company tax rate to the extent that companies are owned by non-residents, in the manner outlined in Annex D of the Issues Paper; and

- an increase the foreign investor tax credit (FITC) on income from foreign portfolio equity investments.

We strongly oppose the alternative approach proposed by the Review which involves limiting income tax reductions to certain types of activities, rather than a general reduction for all non-resident owned companies. For example, the Review has proposed that such tax reductions could be limited to foreign equity investment in:

- new productive activities;

- new productive activities in export industries; or

- new productive activities in certain industries or in certain regional development zones.

We accept that it is possible to mount a case in theory for limiting tax reductions to investments that are more sensitive to New Zealand tax (ie those that are not generating significant economic rents). Indeed, the 'optimal' rate of tax to apply to non-resident investors would vary inversely in proportion to the responsiveness of investment decisions to the rate of New Zealand tax.

However, we do not believe such an approach is either feasible or desirable. In practice, it would be difficult to identify those types of non-resident investments that are likely to be more sensitive to New Zealand tax. None of the three alternative approaches outlined above is likely to provide a reliable guide. As noted by the Review, the first approach, which involves limiting the tax reduction to foreign equity investment in new productive activities, is unlikely to be desirable since there are good reasons for applying the reduction to both old and new investments. Similarly, it is far from clear that national welfare would be improved by the second and third approaches, which involve limiting the tax reduction to foreign equity investment in certain activities, industries or regional development zones. On the contrary, we believe such approaches would:

- signal New Zealand's return to the provision of highly selective tax concessions for those investors who successfully lobby the government to receive preferential treatment; and

- further reduce, rather than improve, the quality of foreign investment in New Zealand.

Taxation of New Zealanders' foreign-sourced income

We agree with the Review that New Zealand's current tax treatment of the foreign-sourced income of residents is in need of reform. As discussed in sections 3.2.2 and 4.2.5 of our first submission, residents tend to be:

- overtaxed on their investments in non-grey list countries, since the income from those investments is taxed as it accrues under the CFC and FIF regimes, whereas the income from most domestic investments is only taxed when it is realised; and

- undertaxed on their investments in grey list countries, since the income from those investments is not subject to the CFC and FIF regimes and resident companies can claim credits for any foreign tax they pay on income from those investments under the underlying foreign tax credit (UFTC) regime.

These significant differences in tax treatment inevitably reduce the overall quality of investment by distorting both the domestic and foreign investment decisions of residents.

At the same time, we recognise that redesigning the regime is not an easy task. As noted by the Review, the ideal is a regime that is sustainable, minimises the deadweight costs of taxation, and complies with New Zealand's international treaty obligations. In practice, however, such a regime is extremely difficult to design. As outlined below, we believe that there are problems with all of the possible options for reforming the New Zealand's current tax treatment of foreign-sourced income identified by the Review.

Foreign tax credits

The Review has identified two potential approaches to the treatment of foreign tax credits.

One approach is to allow credits for all foreign taxes paid by non-residents. We agree with the Review that it will be necessary for New Zealand to continue to recognise the foreign tax credits provided by our double tax treaty partners.

However, it is far from clear that it is in New Zealand's best interests to continue to provide credits for foreign taxes levied by non-treaty partners. As noted by the Review, the provision of credits for such foreign taxes might improve the quality of residents' foreign investment decisions to some extent by reducing disparities in the rates of tax that New Zealand applies to income from investments in treaty and non-treaty countries. However, we are not aware of any research that suggests that this efficiency gain is more than sufficient to offset the amount of revenue that New Zealand gives away to foreign revenue authorities in non-treaty countries via those credits. Unless the Review can establish that this is the case, we believe it would be preferable not to provide credits for foreign taxes levied by non-treaty partners.

The other, more radical, option proposed by the Review is to tax residents on the income they are presumed to derive from their foreign investments, rather than the income they actually derive (the risk-free return method). Under this approach, residents would not be able to claim credit for any of the foreign taxes they paid on their actual foreign-sourced income. As noted by the Review, this approach needs to be examined in much greater detail. In particular, it is important to consider:

- the potential impact of such a reform on patterns of investment by residents. The removal of all foreign tax credits would improve the quality of residents' foreign equity investment decisions to some extent by applying a more uniform effective rate of New Zealand tax to those investments. However, it is possible that the effective rate of New Zealand tax imposed on foreign equity investments would still be less than that imposed on similar investments in

New Zealand, thereby continuing to encourage residents to invest offshore rather than domestically; and

- the manner in which New Zealand's double tax treaty partners are likely to respond to such a move. There is a risk that those treaty partners could interpret the move as a decision by New Zealand that it does not want to tax the offshore income of its residents, thereby leaving the taxation of that income potentially open to those treaty partners.

Grey list

We agree with the Review's conclusion that it would be desirable to repeal the grey list provided that it is possible to develop a suitable regime for the taxation of the foreign-sourced income that residents derive from their investments in grey list jurisdictions.

However, we see very little merit in replacing the grey list with an 'active/passive' distinction for income from investments in jurisdictions currently on the grey list (ie non-black list investments) as a means of reducing compliance costs.

At the moment, New Zealand residents in effect receive a subsidy from the government if they invest in grey list jurisdictions as opposed to domestic investments or investments in non-grey list jurisdictions.

Under option 1, the grey list would be repealed, income from 'passive' (ie portfolio) investments in non-black list jurisdictions would be subject to taxation under the RFRM whereas income from 'active' (ie non-portfolio) investments in those jurisdictions would only be subject to New Zealand tax on repatriation. The scope of the CFC and FIF regimes would be limited to investments in black list countries.

This approach has the potential to reduce differences in the effective rates of tax applying to income derived from portfolio investments in non-black list jurisdictions and New Zealand. However, in so doing, it would also introduce new disparities in the effective rates of New Zealand tax applying to income from 'active' and 'passive' investments in non-black list jurisdictions. The government would continue to subsidise residents to undertake 'active' investments in non-black list jurisdictions as opposed to alternative investments in New Zealand and black-list jurisdictions. As a result, it is not clear that such an approach would improve the quality of residents' investment decisions or reduce the administrative or compliance costs associated with the taxation of residents' foreign-sourced income.

For these reasons, we do not favour option 1. Rather, we believe it would be preferable to explore options 2 and 3 in greater detail. Options 2 and 3 both involve a more extensive application of the RFRM than option 1. Under option 2, the income from all offshore equity investments would be subject to the RFRM, whereas under option 3 the RFRM would be extended to include the income that residents derive from listed investments in New Zealand.

As outlined in paragraph 144 of Chapter 6 of the issues paper, options 2 and 3 are novel and there are numerous issues that would need to be resolved satisfactorily before such options could be recommended. Consequently, we believe the best course of action at this stage is to prepare a separate discussion document that analyses them in greater detail.

In particular, we see merit in exploring Option 2 further, since it appears to have the potential to improve the quality of residents' offshore investment decisions, even though it would continue to tax those foreign investments at concessionary rates of tax in relation to domestic investments (since foreign investments would only be subject to tax on the inflation-adjusted, risk-free rate of return).

Attracting and retaining 'high net worth' and highly skilled individuals

The high rates of tax that New Zealand currently imposes on the income of its residents make it much more difficult to attract and retain 'high net worth' and highly skilled individuals.

As discussed in section 4.2.2 of our first submission, the first response to this problem should be to significantly reduce the rates of tax it imposes on its residents. By reducing income tax to a maximum of, say, 25 percent in the medium term, New Zealand would send a strong signal to both residents and potential residents that it is committed to attracting and retaining both high net worth and highly skilled individuals.

The other potential options for reform identified by the Review would involve either:

- replacing the current 'brightline' distinction between 'residents' and 'non-residents' with a 'domicile rule' (similar to that applying in the United Kingdom) that would exempt New Zealand residents who are not domiciled in New Zealand from the CFC and FIF regimes; or

- introducing a 'tax cap', which would limit the amount of tax that would have to be paid by any individual to a certain specified amount.

The first approach would only provide tax relief for those residents who plan to spend large amounts of time outside New Zealand and who hold, or would like to hold, significant investments in non-grey list jurisdictions. In conjunction with a lower maximum rate, our preference would be for the second 'tax cap' approach, since it would provide tax relief for all high income residents regardless of their patterns of investment.

In our first submission we suggested that this threshold could be set at quite a high level, say $500,000, to ensure that the amount of tax paid by high-income individuals is more than sufficient for those individuals to:

- cover the cost of the public goods and services they consume: and

- make a significant contribution to funding the welfare services for individuals on low incomes.

Such an approach has a number of advantages. It would help attract entrepreneurs and other skilled and internationally mobile talent to New Zealand, and help to retain residents in the same categories who would otherwise migrate – resulting in a partial or complete loss of the tax they would otherwise pay in New Zealand. It would also eliminate the tax disincentive for high-income individuals to engage in additional work and investment, since they would be required to pay the same lump sum of tax regardless of their income. In addition, it would reduce the incentive for high-income individuals to engage in tax planning aimed at reducing their tax liabilities. Many high-income individuals would probably prefer to pay the lump sum tax rather than employ lawyers and accountants in an attempt to reduce their tax liabilities.

The Review indicates that only a small number of taxpayers pay more than $1 million in tax. We suspect the revenue forgone by applying a tax cap would be more than compensated by the retention or attraction of taxpayers who would otherwise be lost to New Zealand.

Neither of the options suggested by the Review would provide significant tax relief for highly skilled individuals who are just starting out on their careers. The only approach that will successfully attract and retain such individuals in New Zealand is to implement significant income tax reductions for all residents.

6 SAVINGS

The Review has also been asked to report on the role that the tax system should play in contributing to the government's wider economic objective of promoting savings.

In order to address this issue, the Review has correctly applied the same basic principles outlined in section 1 of this submission. That is, the Review has sought to:

- identify the nature and extent of the perceived problem and the potential need for government intervention; and

- evaluate the merits of alternative approaches to promoting savings, including reductions in taxes and the provision of selective tax concessions.

We agree with the Review's conclusion that it is far from clear that New Zealand has a 'saving problem' that warrants explicit government intervention. As noted by the Review:

> 10 Existing measures of saving are imperfect and have wide margins of error. Existing aggregate data on New Zealand's savings

record show different trends and levels. The usually quoted measure of household saving from the Household Income and Outlay Accounts (HHIO) of the System of National Accounts shows the savings rate to be low and falling. In contrast, the Household Economic Survey (HES) shows the household saving rate to be high and rising.

11 In measured saving, many items that are investment are counted as current expenditure, with the result that the 'true' level of national saving in understated. The current estimate is that national saving (ie aggregate saving by households, businesses and the government) is two percent of GDP. In fact, a 'true' measure of saving that incorporated items such as investments in education and consumer durables would in likelihood show savings in excess of 20 percent of GDP. Further work is therefore needed before a more comprehensive picture of national saving can be obtained.

Even if New Zealand does have a 'saving problem', we agree with the Review's conclusion that the government should not introduce tax concessions in order to promote savings. Rather, the government should retain the TTE regime for taxing saving. As noted by the Review, tax concessions are more likely to reduce the quality of savings rather than increase the overall level of national savings:

20 We are not convinced that tax concessions would result in higher national savings or that, if they did, the benefits would outweigh the costs due to the distortionary effects of concessions on the quality of people's saving decisions. We therefore favour the retention of the TTE regime for the taxation of savings.

It is important for governments to recognise that the adverse effects of taxation on levels of saving and investment are an unavoidable cost of using the tax system to raise and redistribute revenue.

As discussed in our first submission, we believe that the best approach to encouraging saving, investment and growth in New Zealand is to reduce government spending and hence the amount of tax revenue that needs to raised, and implement lower and more uniform rates of tax.

Rather than increase overall levels of saving and investment, selective tax concessions tend to reduce the quality of saving and investment decisions. That is, those concessions would divert investment from activities that would be more beneficial to the national as a whole. In the absence of expenditure reform, the provision of tax concessions for certain savings vehicles would also:

- erode the tax base, placing an even greater burden on those activities that are not eligible for such concessions;
- provide an open-ended level of assistance which is difficult to monitor and control;
- permit those involved in the provision of such savings vehicles to increase their costs and capture at least some of the tax concessions; and
- encourage other taxpayers to lobby for the extension of similar tax concessions to other forms of investment.

7 COMPLIANCE COSTS

The Issues Paper notes the importance of compliance costs in discussing tax policy but it provides no discussion on the level of those costs now, the factors that contribute to them and ways of addressing the problem.

A major concern of firms is the costs incurred in complying with taxation legislation. Most surveys of businesses rank taxation issues as their most important concern from a compliance cost perspective. This reflects the pervasive nature of taxes and the growing complexity of tax rules and requirements.

Sanford and Hasseldine estimated that compliance costs amounted to 1.9 percent of revenue raised by PAYE, ACC and similar withholding taxes, 1.7 percent of FBT, 7.3 percent of GST and 19 percent of business tax (company, partnership, trusts and sole traders) in 1990. In aggregate, compliance costs were estimated to be equal to 2.5 percent of GDP.[3] At today's GDP, such costs would amount to about $2.6 billion a

3 Cedric Sandford and John Hasseldine (1992), *The Compliance Costs of Business Taxes in New Zealand*, Institute of Policy Studies, Wellington, pp 1-3.

year. They would be about equal to the government's spending on defence and law and order.

A separate study of the compliance costs faced by farmers found that taxation was the main source of such costs. It affected 99 percent of surveyed farmers. The median cost of complying with tax requirements was put at $3,220 a farmer.[4]
Compliance costs fall disproportionately on small businesses, such as farms, because many of the costs of complying with tax rules do not increase proportionately as organisations increase in size. The cost involved in organising the payment of provisional tax, for example, is much the same whether a firm is required to pay $1,000, $10,000 or $100,000.

Successive governments have sought to reduce compliance costs. Progress over the past few years has, however, been disappointing. On the one hand, large numbers of individual taxpayers are no longer required to file tax returns at the end of the tax year, firms can file certain tax returns electronically and the Inland Revenue Department's processes for supplying some information such as stationery items have improved significantly.

On the other hand, the tax system has been made more complex by the adoption of a less uniform income tax scale. The previous government's moves to widen the tax scale by concentrating tax reductions on lower statutory rates led to the type of problem illustrated by the TOLIS (Taxation of Life Insurance and Superannuation) exercise. This demonstrated that there are no satisfactory ways of reducing the distortions created by a disparate scale without imposing high compliance costs. The complexity of the tax system has also been exacerbated by a large expansion of support for low-income working families which is delivered through the tax system and by a persistent and voluminous stream of legislation aimed at countering avoidance schemes and correcting legislation.

The decision of the present government to implement a top personal income tax rate of 39 percent illustrates the growing complexity of tax arrangements. To implement

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4 Peter Jarvis and Roger Wilkinson (1998), 'Survey of Compliance Costs of New Zealand Farmers: A Study of Costs and an Exploration of Issues', MAF Information Paper No 24, Ministry of Agriculture and Fisheries, Wellington, p 2.

the policy it was necessary for parliament to pass 47 pages of legislation that added 38 new sections to the Income Tax Act 1994 or the Tax Administration Act 1994. In addition, the government has now introduced a bill which will amend the legislation passed last year.

The government released in May 2001 a consultative document which proposes a number of simplification measures. Some business and other commentators initially welcomed the proposed measures. A close inspection of them, however, indicates that they would do little to address the heavy burden that tax requirements impose on firms and individuals. They would not, for example, reduce the complexity of the tax system to the extent that all the measures imposed to shore up the 39 percent rate added to it. The same is true of the tax proposals recommended by the ministerial panel on business compliance costs which reported in July.[5]

A substantial reduction in the compliance costs of taxes requires attention to be directed to broad policy issues. The following steps are required:

- The adoption of more uniform rates of tax. Much of the complexity of the tax system arises from disparate rates of tax. Such rates of tax lead to measures designed to tax income earned by individual taxpayers through independent legal entities such as companies and trusts at their marginal tax rates. It also leads to steps to reduce tax avoidance through the splitting of income among taxpayers on different marginal tax rates and to tax people on low incomes at their appropriate marginal rates. A near-uniform rate of tax would, for example, allow the tax system to be simplified substantially. The imputation system and the taxation of most dividends and interest in the hands of individual taxpayers could, for example, be abolished. The introduction of the new personal rate of tax of 39 percent from 1 April 2000 led to the replacement of a flat rate of FBT with multiple rates, and to the adoption of a new regime which attributes certain income earned by so-called service companies and trusts to individual taxpayers. These measures could be abolished.

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5 Ministerial Panel on Business Compliance Costs (2001), *Finding the Balance: Maximum Compliance at Minimum Cost*, Ministry of Economic Development, Wellington.

- The introduction of substantially lower rates of tax. Other things being equal, the higher are marginal rates of tax the greater is the incentive to avoid taxes. Consequently, the rules required to limit avoidance become more complex and burdensome as marginal rates of tax rise.

- A move to greater stability and certainty in tax policy. Because the tax system has been under strain to generate the level of revenue required to fund an excessively large government sector, it has been subjected to massive changes since 1984. Many were beneficial from an overall community welfare perspective. However, there is now a need for greater stability and certainty in the tax rules. The quality of tax legislation needs to be improved so that the need for subsequent amendments to correct errors is reduced. The habit of passing at least three amendment acts each year needs to be broken.

- The quality of information and advice available to taxpayers from the Inland Revenue Department needs to be expanded and upgraded. While the Department claims to be very efficient at processing tax payments, it can be difficult to obtain factual information and guidance on departmental practice and long delays are commonly encountered before the department answers the telephone. Small firms engaged in relatively straightforward business activities and individuals should, if they wish, be able to comply with their tax obligations without the need to employ a tax adviser. This is becoming increasingly difficult for firms because the tax system is too complicated and the Inland Revenue Department does not provide information that is required. Recent governments have conferred advantages on taxpayers who engage the services of tax accountants and lawyers. Taxpayers may, for example, be permitted to file their returns later than other taxpayers. The latest simplification proposals would provide protection from penalties for taxpayers who outsource their payroll functions.

- A realistic assessment needs to be made of the merits of policy proposals. The introduction of higher rates of resident withholding tax payable on interest earned by companies, for instance, imposed significant compliance costs on companies (other than those that are trustees) with little apparent efficiency gain. The argument was that companies were gaining a timing advantage by paying withholding tax at 19.5 percent instead of 33 percent. But this advantage is minimal where firms pay provisional tax as most do. The degree of within-year accuracy implicitly sought is far greater than that which applies to other forms of income.

We consider there should be more emphasis on compliance cost issues in the Review's final report. 'Tax simplification' exercises are largely doomed to failure unless the complexity of the tax system is reduced by changes to its structure. The review should add a discussion of compliance cost issues to its arguments for a lower and more uniform income tax scale. Eliminating unnecessary taxes such as excise duties could also reduce administration and compliance costs.

8 LOCAL AUTHORITY TAXATION

The Review's terms of reference do not limit its scope to central government taxation. Local authority rates are a significant tax, contributing about 5 percent of the total take.
Rating issues are currently under examination in a government review of local authority funding powers. Nevertheless, the Review should arguably look at this part of the tax system because of its relationship with other issues it is dealing with. For example, many reactions to its proposals for taxing housing pointed out that houses are taxed through the property-based rating system.

In our view there are a limited number of core public goods functions that local government needs to undertake, and some of them can be financed by user charges. Accordingly there should be no need for a major tax base for local government. The property tax base is therefore adequate for local authority revenue purposes. It should be as broad as possible (without exemptions for Crown land, for example) and there should be no discrimination against commercial or industrial ratepayers through differential rating. In some cases we see it as reasonable to apply special rates or charges where certain groups benefit disproportionably from council services eg local flood protection. We do not see a need for revenue sharing by central government. This would have the undesirable effect of driving a wedge between local government responsibility for spending and funding decisions.

Local authority rates have risen excessively over the past 10 years – by around twice the rate of inflation. This increase has its origins in spending activities by councils that have extended well beyond their core functions. We are concerned that current proposals to grant councils a 'power of general competence', increase their responsibility for social, economic, cultural and environmental matters, and promote central-local government 'partnerships' will encourage expansionist tendencies. As with central government spending, we suggest the Review draws attention to the fact that reducing the local authority tax burden requires reductions in spending, in the interests of promoting economic efficiency and growth, and comments on the desirable features of the base and structure of rates as part of the New Zealand tax system.