NEW ZEALAND BUSINESS ROUNDTABLE

Submission on the Business Tax Review

SEPTEMBER 2006

1. Overview

1.1. This submission on the *Business Tax Review: A Discussion Document* (the discussion document) is made by the New Zealand Business Roundtable, an organisation comprising primarily chief executives of major New Zealand business firms.[1] The purpose of the Business Roundtable is to contribute to the development of sound public policies that reflect overall New Zealand interests.

1.2. The Business Roundtable welcomes the government's willingness to examine a reduction in the rate of company tax, but personal tax also needs to be reduced. It is opposed to the possible tax subsidies outlined in the discussion document. Their adoption would constitute an undesirable departure from the 'broad base, low rate' strategy that the McLeod Review and all governments from 1984 to 1999 have endorsed.

1.3. The Business Roundtable submits that meaningful personal and business tax cuts would best meet the government's objectives of boosting productivity and economic growth, and improving competitiveness, particularly with Australia. An alternative tax proposal advanced by a broad coalition of business groups is summarised.

1.4. The proposed tax reductions would be largely funded by lower growth in spending than currently projected, modest reductions in low quality spending and tax concessions, a lower operating surplus, and the revenue gains from higher economic growth resulting from the proposed package. An increase in other taxes, such as GST, is not required to fund tax cuts. The Business Roundtable is also opposed to the introduction of a payroll tax.

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[1] Cullen, Michael and Dunne, Peter (2006a), *Business Tax Review: A Discussion Document*, Inland Revenue Department, Wellington.

1.5. The balance of this submission is presented in 4 sections. The next section (section 2) summarises the context of the review by examining the thrust of the 1984-1999 tax reforms, the McLeod Review, and relevant tax policies put forward by political parties at the 2005 general election. The discussion document is examined in section 3. An alternative tax strategy is presented in section 4. The conclusions are contained in section 5.

2. The context of the review

Thrust of tax reform 1984-1999

2.1. Tax reform has been a focus of public policy since 1984. The efficiency of the tax system has been substantially improved. We now have two main taxes, income and GST, which conform more closely with sound tax principles.

2.2. The income tax base was broadened by reducing or abolishing many corporate and personal tax exemptions and concessions, for instance for investment, fringe benefits, and savings through superannuation funds. The introduction of GST almost 20 years ago broadened the indirect tax base and enabled a range of highly discriminatory indirect taxes, including a narrow sales tax and certain stamp duties, to be abolished.

2.3. The broadening of the direct and indirect tax bases enabled lower and less disparate statutory rates of tax to be applied. This approach is encapsulated in the phase, 'broad base, low rate'. It enhances the efficiency of the economy by reducing the extent to which taxes distort consumption and investment patterns, given the government's revenue requirement.

The McLeod Review

2.4. The McLeod Review undertook the first formal stocktake of New Zealand's tax system since the post-1984 reforms. The group’s

report is widely respected by tax professionals and the business community. It should form the blueprint for tax policy.

2.5. The McLeod Review "addressed all the major elements of the New Zealand tax system".[2] It reported that the tax system was generally sound – a rare finding for inquiries of its type because they are usually established when major change is overdue.

2.6. The Review endorsed the thrust of the post-1984 tax reforms:

> We conclude that radical restructuring is not required. The broad architecture of the tax system is sound … We generally conclude that the … reform programme has been a success and should not be reversed.[3]

2.7. Of particular significance in relation to the current review of business tax, the McLeod Review observed:

> The broad base low rates approach developed over the last twenty years is sound and should be continued. New Zealand reforms should focus on incremental improvements to what we have, and *there should be a prejudice against deviation from this approach, so that exceptions are only made where a substantial burden of proof is discharged*.[4]

2.8. The following assessment by the Review is also important in that context:

> … good tax policy design would ideally align the company, trust and top individual marginal income tax rates. Any alternative opens the tax system to abuse, complexity and distortion. This puts a severe constraint on designing a good rate structure.[5]

2.9. This was an implicit criticism of the increase in the top personal rate of income tax to 39 percent from April 2000 which severed the alignment of the top personal, company and trust tax rates. Several of the government's tax measures since 1999, such as the attribution rule which applies to certain income from personal exertion, had to be introduced as a consequence of setting the

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[2] McLeod, Robert *et al* (2001), *Tax Review 2001: Final Paper*, Letter of Transmittal, http://www.treasury.govt.nz/taxreview2001.

[3] *Ibid*, p I.

[4] *Ibid*, p II (emphasis added).

[5] *Ibid*, p VII.

company rate below the top personal rate of tax.

2.10. The Review's key recommendation proposed the adoption of a lower and flatter income tax scale. It suggested:

> … a move to a two-step personal income tax scale (18% up to $29,500 and then 33 percent) as the direction of possible reform. The company and trust rate would then be aligned to the 33 percent rate.[6]

2.11. Even so, the Review warned that:

> At these tax rates … New Zealand would be likely to remain an unattractive destination for internationally mobile capital and people.[7]

The 2005 election

2.12. Tax reductions were a feature of the 2005 election. Personal and company tax cuts were advocated by the National Party but were opposed by the Labour Party. The National Party, New Zealand First and United Future campaigned for a company tax rate of 30 percent. United Future went further, proposing a series of measures designed to provide:

> … tax benefits for every taxpayer, for every family, for all companies, every business, all superannuitants, every property owner and every charitable and not-for-profit organisation in New Zealand.[8]

2.13. United Future's tax policy also states that its aim is to:

> Further lower tax rates, as economic conditions allow, with the goal of establishing a tax rate which is comparatively flat.[9]

2.14. Labour's confidence and supply agreements with New Zealand First and United Future respectively committed the government to:

> Conduct a review of the current business taxation regimes with the view of ensuring the system works to give better incentives for

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6 *Ibid.*
7 *Ibid.*
8 Copeland, Gordon (2005), 'Tax Cuts: Comparing Labour, National, UF', press release, 29 August, http://www.scoop.co.nz/stories/PA0508/S00750.htm.
9 http://www.unitedfuture.org.nz.

> productivity improvements and improved competitiveness with Australia.[10]

2.15. The speech from the throne following the 2005 election stated:

> The review of the structure of corporate taxation … will … be designed to take a wide-ranging look at our current system of corporate taxation with an emphasis on practical signals to lift productivity.[11]

2.16. In December 2005 the minister of finance stated:

> Although the scope of the review is still being considered, we envisage some very bold measures emerging. It will not be a matter of tinkering with the tax rules.[12]

2.17. At the opening of parliament in February 2006, the prime minister placed the business tax review in the context of the government's programme of economic transformation or economic growth:

> Economic transformation has always been central to this government's economic policy …
>
> We are passionate about New Zealand and its potential – and we'll do whatever we can to see this country succeed. Now it's time to move to the next level in the economic transformation agenda …
>
> The top priorities will be:
>
> - The major review of the structure of business taxation …[13]

2.18. In the light of these signals a comprehensive and thorough business tax review, focused on tax reductions, was widely expected.

3. The discussion document

The options

3.1. The discussion document outlines a range of options on which submissions are sought. None of the options is proposed or

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10 New Zealand Labour (2005), 'Confidence and Supply Agreement with New Zealand First', img.scoop.co.nz/media/pdfs/0510/LabourNZF.pdf and New Zealand Labour (2005), 'Confidence and Supply Agreement with United Future', img.scoop.co.nz/media/pdfs/0510/LabourUF.pdf.

11 Cartwright, Silvia (2005), 'Speech from the Throne', 8 November, http://www.scoop.co.nz/stories/ PA0511/S00104.htm.

12 Cullen, Michael (2005), 'Timetable for Business Tax Review', press release, 20 December, www.beehive.govt.nz/Print/PrintDocument.aspx?DocumentID=24661

13 Clark, Helen (2006), 'Prime Minister's Statement to Parliament 2006', 14 February, http://www.scoop.co.nz/stories/PA0602/S00173.htm.

recommended by the government. They represent a menu from which the government may select.

3.2. The most significant option is a reduction in the company rate of tax to 30 percent – the same rate as Australia's company rate – at a cost of $540 million. A 'deep' cut to the company tax was considered but rejected by the government. According to the discussion document, submissions on a deep cut are welcome but submitters should make it clear how they propose to fund it. (We do so below). An increase in GST and the introduction of a payroll tax were ruled out in the discussion document.

3.3. Other options relate to tax base and compliance issues. They include the following (the government's estimate of cost is noted where it is included in the discussion document):

- targeted tax concessions for research and development ($45-$350 million), export market development and enhancing skills in the workforce;
- a relaxation of loss continuity rules where certain 'upfront' expenditure is incurred, for instance for petroleum exploration or development, and forestry development;
- the introduction of tax deductions or amortisation allowances for certain spending of a capital nature which is not presently deductible (which the discussion document terms 'blackhole spending') at a cost of $150-$300 million;
- an increase in depreciation loadings in excess of economic rates of depreciation for new assets from the current 20 percent to 30 or 40 percent ($120-$230 million), and/or an extension of the 20 percent loading to second-hand assets ($90 million);
- a reduction in current depreciation loadings to 10 percent or their abolition (saving $120-$250 million);

- an increase in a range of thresholds, for instance for the write-off of low value assets ($170 million) and assets that have been depreciated to a low value, and for fringe benefits.

3.4. The fiscal parameters within which the review is being conducted have not been disclosed, although the discussion document states that the government's revenue strategy seeks to maintain the tax to GDP ratio at around current levels. The implication is that the measures proposed can only be funded from other tax changes or a windfall increase in the tax to GDP ratio.

Comment on the options

3.5. The government's broad objectives of improving productivity and competitiveness, especially with Australia, and boosting the rate of economic growth warrant support. Most people would welcome higher incomes and the opportunities that growth provides.

3.6. Despite statements by the government since 1999 that lifting New Zealand's per capita income above the OECD median is a top or main priority, Treasury's forecasts of GDP per capita indicate that it is falling well short of this objective. This is no surprise because the government has failed to establish a credible growth strategy. Its policies have been focused on the redistribution of income, with programmes such as Working for Families, rather than on the creation of wealth.

3.7. The tax options outlined do not constitute a growth strategy. Lower government spending relative to GDP and hence a lower overall tax burden should form part of such a strategy. Tax changes which left the tax to GDP ratio unchanged would have limited impact. Moreover, an effective growth strategy also needs to address government regulation and the ownership of state enterprises as well as the levels of spending and taxation. Such a strategy would improve the competitiveness of New Zealand producers by lowering

their costs, for instance for inputs bought from state-owned enterprises.

3.8. The government's willingness to examine the rate of company tax is welcome. However, a small cut in the rate of company tax (with no change in personal tax) and Muldoon-like tax concessions with no change in the overall tax burden would, at best, have a small effect on productivity or the rate of economic growth.

3.9. The Business Roundtable submits that meaningful personal and business tax cuts, largely funded by lower growth in spending than currently planned, would best meet the government's objectives. An increase in other taxes, such as GST, is not required to fund tax cuts and is not recommended. We are also opposed to the introduction of a payroll tax.

The company tax rate option

3.10. Although New Zealand's company rate of tax was set well below that of the average for the OECD when it was first applied in 1989/90, other countries have subsequently reduced their rates. It now lies between the OECD weighted and unweighted average rates.

3.11. A reduction in the rate of company tax alone is likely to have a limited effect on the level of investment for the following reasons:

- The interaction of personal and company rates of tax affect the level of domestically financed investment. If the personal rate of tax exceeds the company rate of tax, the effective rate of tax on new equity-financed investment is the personal rate of tax. A taxpayer on the top personal rate of tax earns a dollar of income, pays 39 cents in tax and then invests the net income through a company. If a dollar of income earned through a company is distributed to an individual shareholder on the top rate of tax, the effective rate of tax on that income

is also 39 percent. In these circumstances, a reduction in the company rate of tax with no change in the personal tax rates has no direct effect on the effective rate of tax payable on new investment and thus can have no direct impact on the level of investment. People on high personal tax rates supply most savings.

- Company income that is not distributed initially bears only the company rate of tax. As a result existing companies are encouraged to retain income and reinvest when the rate of tax paid by their shareholders exceeds the rate of company tax. Thus a reduction in the company tax rate with no change in personal rates of tax would encourage existing companies to expand relative to new companies. This is an unwarranted bias.

- Although most business activity is conducted through companies, unincorporated enterprises such as sole traders and partnerships may account for between 20 and 40 percent of all such activity (depending on the measure used). Unincorporated enterprises are particularly prominent in the primary and service sectors. A reduction in the company rate of tax can have no direct impact on their investment decisions. It may, however, encourage such sole traders and partnerships to incorporate for tax reasons rather than genuine business reasons.

- The required rate of return on investment with an open capital market can be no higher than the world rate of return grossed up for domestic taxes, otherwise there is scope for arbitrage. Company tax is the main domestic tax on inward foreign investment. Thus a lower rate of company tax would tend to lower the required rate of return on new investment generally and would lead to higher investment than otherwise (other things being equal). To the extent that the effective rate of tax on domestic investment is not reduced (for instance, because

the personal rate of tax is binding), higher investment is likely to be accompanied by a reduction in domestic investment and an expansion of foreign investment.

- Most businesses that operate through incorporated entities in two or more countries have some flexibility as to where they report their net income for tax purposes. They take account of home and host country tax regimes. From a New Zealand perspective, the interaction of Australian and New Zealand tax arrangements is particularly important. If the New Zealand company tax rate is higher than Australia's rate, firms operating on both sides of the Tasman will tend to report their income in Australia and *vice versa*. A reduction in the New Zealand company tax rate relative to the Australian rate would be a step in the right direction but it would be vulnerable to further moves by Australia which is cutting taxes generally. Thus the option of a 30 percent company rate is likely to be insufficient to stop the erosion of the New Zealand tax base over the medium term.

- In discussing trans-Tasman tax rates, the discussion document correctly observes that statutory rates of tax are not the “whole story” as far as competitiveness and productivity are concerned. It refers to Australia's capital gains tax, state payroll taxes and stamp duties. The document fails, however, to note that the ratio of total spending to GDP – the best overall measure of the tax burden – is much lower in Australia than in New Zealand. The OECD expects Australia's spending ratio to be 34.8 percent in 2006 compared with 42 percent for New Zealand.[14] These ratios take spending at all levels of government into account. In discussing relative tax

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[14] OECD (2006) *Economic Outlook 79*, June, annex table 25, http://www.oecd.org/document/61/0,2340,en_2649_201185_2483901_1_1_1_1,00.html.

burdens in New Zealand and Australia, the minister of finance has often ignored this key point.

3.12. Personal rates of tax, which the government has put outside the scope of the business tax review, must be examined in conjunction with the company rate because they are inter-related. A change in the income level at which the top rate applies (the tax threshold) would not lower and flatten the tax scale as recommended by the McLeod Review and would not alter the incentives faced by most taxpayers. Other rates of tax such as the trustee and fringe benefit rates and the rates payable on earnings through savings vehicles must also be considered because they are also related to personal rates of tax.

Tax base options

3.13. By 1984 the company tax was raising little revenue because the base had been eroded by a plethora of tax exemptions and concessions. Most were subsequently removed for good reason. Tax subsidies mean tax rates or taxes on other activities need to be higher to maintain the same level of government revenue.

3.14. The discussion document offers no plausible argument for believing that targeted tax subsidies would contribute materially to higher productivity or improve overall competitiveness with Australia. Spillover benefits, which research and development, export market development and enhancing skills are said to generate, are ubiquitous. Most do not warrant government action. Some of the affected activities are already subsidised. A special provision, introduced from 2005/06, allows firms to defer claims for research and development expenditure where such claims may otherwise have produced a loss that would be unable to be carried forward because of a change in the shareholding of a company. The government would need to show that the benefits of intervention outweigh the cost. One test might be whether the benefit would be greater if taxes were simply cut. The discussion document does not

come close to discharging the burden of proof for departing from the broad base, low rate approach endorsed by the McLeod Review.

3.15. If the government subsidises a particular activity it can expect that investment in the activity will expand. However, it does not necessarily follow that overall output or productivity is increased. High subsidies may lead to waste, for instance 'over-investment' in plant and machinery. Research and development might be undertaken under contract overseas and the commercialisation of any worthwhile discoveries might take place in another country. A recent Australian Treasury paper concluded, "… the effectiveness of direct support and tax concessions in influencing R&D is unclear."[15] It also found that the relationship between research and development spending and the generosity of the tax system towards such spending is, if anything, "negative across countries."[16]

3.16. It is often noted that New Zealand's spending on research and development is low compared with most other OECD countries. A survey by Statistics New Zealand found that private sector spending on research and development in 2004 was equal to 0.47 percent of GDP. However, this ratio almost doubled between 1996 (when it was 0.26 percent) and 2004.[17] The comparable ratio for Australia was 0.95 percent of GDP in 2004/05 and it has also grown strongly over recent years.[18] The opening of both economies to international competition is likely to have contributed to the rapid rise in private sector spending on research and development in both countries. The structure of industry, including the absence of large private sector defence, space and pharmaceutical industries, may help to

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15 Davis, Graeme and Tunny, Gene (2005), 'International Comparisons of Research and Development', *Economic Roundup Spring 2005*, The Treasury, Canberra, p 74, http://www.treasury.gov.au/contentitem.asp?NavId=&ContentID=1042.

16 *Ibid*.

17 Statistics New Zealand (2006), 'Research and Development Survey 2004', August, http://www.stats.govt.nz/products-and-services/info-releases/research-development-survey-info-releases.htm.

18 Australian Bureau of Statistics (2006), 'Research and Experimental Development, Businesses 2004-05', http://www.abs.gov.au/AUSSTATS/abs@.nsf/Lookup/8104.0Main+Features12004-05?OpenDocument.

explain why some developed countries spend more than New Zealand and Australia on business research and development.[19]

3.17. Some options such as tax subsidies for export market development and skills enhancement are so poorly developed that elementary information on them is not included in the discussion document. Export market development expenditure would soon include thinly disguised overseas holidays such as trips to the Olympics and other sporting and cultural events. An army of tax officials would be required to police allowable expenditure. Even if such an army were raised, the concessions may give rise to scandals just as subsidies and lax spending rules in the tertiary sector gave rise to twilight golf and radio sing-along courses, and would undermine the integrity of the tax system.

3.18. By putting dubious tax subsidies on the table, the government is inviting lobbying for other concessions. This point also applies to the proposal to allow employers to contribute to employees' KiwiSaver schemes on a tax-free basis. The pre-1984 income tax base was not eroded by a single decision but gradually by many decisions over time. PricewaterhouseCoopers tax partner John Shewan recently observed that over 90 tax concessions were listed in a 1981 *Tax Information Bulletin*.[20]

3.19. Some specific points on other options are as follows:

- Economic rates of depreciation should be deductible for tax purposes. Loadings beyond such rates are a subsidy for investment in particular assets and should be withdrawn rather than increased. The abolition of the present loading could help fund meaningful tax cuts. Recent company tax rate cuts in Australia were partly funded in this way.

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[19] Davis and Tunny advance this argument in respect of Australia. See Davis and Tunny (2005), *op cit*, p 68.

[20] Comment by John Shewan at The Dunes Symposium, New Zealand Business Roundtable, Waiheke Island, 17 August 2006.

- The cost of depreciation options should be computed in present value terms over the life of the affected assets and not over the first five years, which is grossly misleading.

- Concessionary deductions for capital spending in the initial years and restrictive loss carry forward rules cause the problem which the 'upfront' spending option is intended to address. The concessions should be removed and the loss carry forward rules should be revisited on a principled basis.

- The 'blackhole' spending is generally of a capital nature, which should not be deductible, just as related gains are not taxable.

- The options related to tax compliance are trivial. They would be far outweighed by the additional compliance costs that would be incurred in shoring up a wider gap between the top personal rate of tax and the company tax rate if the latter alone is reduced, and in implementing targeted tax concessions if they are adopted. A far more serious effort to reduce compliance costs is warranted. Taxation is commonly ranked as the top area of concern to businesses from a compliance cost perspective. The best strategy would be to move toward a lower and flatter tax structure, ideally with a single rate.

- There is no need to introduce new taxes like a payroll tax or to increase GST. Forecast growth in spending should be reduced to fund tax cuts.

3.20. In passing, we note that the discussion document states:

> The government is not prepared to countenance an increase in the rate of GST as a method of funding a deep cut in the company rate. The simple reason is that high-income households save a greater

> proportion of disposable income than do low-income households, so an increase in the rate of GST falls disproportionately on the latter.[21]

On this argument, the tax subsidy for KiwiSaver is much more regressive because it also benefits disproportionately people on higher incomes who can save a higher proportion of their income. However, the analysis of the incidence of GST contained in the discussion document is unduly static and misleading. Examined on a life cycle basis, GST is best viewed as a proportional tax because, leaving aside gifts and bequests, all income is ultimately spent.

3.21. The tax options outlined in the discussion document have turned out to be anything but “very bold”, “far reaching” or “major”. The quality of policy analysis reflected in the discussion document is easily the lowest since 1984. The ministers of finance and revenue may claim that "the government is not interested in an ill-thought out, politically driven lolly scramble" but what do they expect when accepted tax principles and rigorous analysis are tossed overboard?[22] The minister of finance's assertion that the business tax review "is the largest re-think of the business tax regime in nearly twenty years" is hard to take seriously.[23]

4. An alternative tax strategy

4.1. In April this year the Business Roundtable, Chambers of Commerce and Federated Farmers, with the support of the Institute of Chartered Accountants, jointly indicated to the government what they hoped would come out of the business tax review. The details of the strategy are presented in an annex and summarised below.

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[21] Cullen and Dunne (2006a), p 23.

[22] Cullen, Michael and Dunne, Peter (2006b), 'Business Tax Review Discussion Document Released', press release, 25 July.

[23] Cullen, Michael (2006), 'Speech Notes for Address to Tauranga Chamber of Commerce Lunch', press release, 16 August.

4.2. The submission focused on reductions in personal, company and other tax rates and was designed to:

- improve incentives for investment, employment and productivity;
- encourage economic growth;
- improve the attractiveness of the tax structure internationally; and
- be fiscally responsible.

4.3. A feasible medium-term objective is to reduce the company and top personal rates to 25 percent or below. The Business Roundtable put this view to the McLeod Review. The business organisations' proposal was designed as a step toward that objective.

4.4. The joint submission proposed that the company rate of tax would be reduced to 25 percent by 2009/10 and the top and middle personal rates would be reduced to 28 percent. The recommended rates of tax are set out in the table below.

Proposed Tax Reductions

Tax Rates	**Present**	**2007/08 and 2008/09**	**From 2009/10**
	%	%	%
Company	33	30	25
Top personal	39	35	28
Middle personal	33	30	28

4.5. The Business Roundtable would prefer the top personal and the company tax rates to be aligned but that was not included in the

compromise package. One factor was that each 1 cent reduction in the top tax rate costs $130 million. [24]

4.6. The tax rate changes were estimated to cost about $4.4 billion or 2.7 percent of GDP a year on a static basis once they were fully implemented. This estimate did not take account of the second-round effects on economic growth of lower taxes. When such dynamic factors are taken into account, its cost over the medium term was estimated to be $3.3 billion.

4.7. Although reductions in marginal tax rates are not generally fully self-financing over the medium term, the claim that they do not generate higher output than otherwise is mistaken. One consequence is that dire predictions of a blowout in the government's fiscal deficit generally prove to be unfounded because well-designed tax cuts lead to higher revenue collections than forecast on a static basis.[25]

4.8. We proposed that the tax cuts be funded as follows:

- $2 billion from provisions made in the 2005 budget for new spending or tax measures through to 2009/10 inclusive. This would commit about 35 percent of such provisions.

- $0.5 billion from lower spending or lower tax concessions.

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24 The proposal was developed before the 2006 budget was presented. The 'ballpark' cost of the package has not been revised.

25 See, for example, US Department of the Treasury (2006), 'A Dynamic Analysis of Permanent Extension of the President's Tax Relief', Office of Tax Analysis, http://www.treasury.gov/offices/tax-policy/, Rahn, Richard W (2006), 'Tax Cut Revenue Rewards', *The Washington Times, 22 August* http://www.washingtontimes.com/commentary/20060822-091852-5272r.htm, Sperry, Peter (2001), 'The Real Reagan Economic Record: Responsible and Successful Fiscal Policy', Backgrounder 1414, The Heritage Foundation, March, www.heritage.org/Research/Taxes/BG1414.cfm, Joint Economic Committee of the Congress of the United States (1996), 'The Reagan Tax Cuts: Lessons for Tax Reform', JEC Report, April, www.house.gov/jec/fiscal/tx-grwth/reagtxct/reagtxct.htm, Niskanen, William A and Moore, Stephen (1996), 'Supply Tax Cuts and the Truth About the Reagan Economic Record', Cato Policy Analysis No. 261, Cato Institute, 22 October, www.cato.org/pub_display.php?pub_id=1120. Kudlow, Lawrence and Moore, Stephen (2000), 'It's the Reagan Economy, Stupid', *Washington Post*, 1 February, www.freerepublic.com/forum/a38960de20530.htm and Leach, Graeme (2003), 'The Negative Impact of Taxation on Economic Growth', www.reform.co.uk.

- $1.9 billion from a lower surplus and hence higher debt than forecast. The debt to GDP ratio would be about 1 percent higher than otherwise.

4.9. The minister of revenue, Peter Dunne, stated that the package would require deep cuts in some government services.[26] This is not the case:

- The tax cuts would largely replace new spending proposals that might otherwise be approved. Rather than use most of the provisions for new policies on additional spending, 35 percent would be diverted to growth-enhancing tax reductions.

- Only $0.5 billion would come from lower spending or a reduction in existing tax concessions like the depreciation loading. It is not credible to suggest that low quality spending of $0.5 billion could not be found within a budget of about $50 billion.

- A move towards a lower surplus and a slightly higher level of debt would not be imprudent in present circumstances. The government is currently over-taxing the community by budgeting for large operating surpluses and expanding its assets.

- The personal and business cuts outlined in the package would make a significant contribution to raising productivity and growth, while being fiscally responsible. From both a business sector and an overall community perspective, the package is a much better option than those contained in the discussion document.

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26 *Trans Tasman*, 27 July 2006.

5. Conclusion

5.1. In summary:

- The Business Roundtable welcomes the government's willingness to examine a reduction in the rate of company tax but personal and other business taxes also need to be reduced.

- It is opposed to the possible tax subsidies that are outlined in the discussion document. There are no compelling grounds for them and their adoption would constitute a decisive break with the 'broad base, low rate' policy that the McLeod Review and all governments between 1984 and 1999 have endorsed.

- Such subsidies are not supported by any of the major representative business organisations. We urge the government to base its decisions on sound tax policy principles and to listen to representative business opinion, not isolated voices interested in a “politically driven lolly scramble”.

- In our view the priority focus of the government should be on meaningful personal and corporate tax reductions.

- The tax proposal jointly advanced by several representative business groups would reduce the top and middle personal tax rates to 28 percent and reduce the company rate to 25 percent by 2009/10. It would boost productivity and economic growth, and improve competitiveness.

- The Business Roundtable would prefer to see the top personal and company tax rates aligned.

- The proposed tax cuts can be financed without cutting spending on essential government services. However, they require a slower rate of growth in new spending.

- While a credible growth strategy should include personal and business tax cuts, changes in regulatory, ownership and other policies are also required to increase New Zealand's trend growth rate.

Annex

31 March 2006

Rt. Hon Helen Clark
Prime Minister
Parliament Buildings
WELLINGTON

Copy: Hon Dr Michael Cullen,
Minister of Finance
Hon Peter Dunne,
Minister of Revenue

Dear Prime Minister

The business community at large has welcomed the government's review of business taxation. There is strong business support for the government's commitment to raising the rate of economic growth and to a "bold" review, and the two issues are obviously closely connected.

The business organisations associated with this letter accordingly felt it might be helpful to the government if we were to formulate a collective view of the main elements of what we would like to see come out of the review. You will note that we represent directly or indirectly a very broad cross-section of New Zealand business.

Our main criteria in developing a proposal were to reform business taxation in a way that would benefit investment, employment, productivity, competitiveness and economic growth in New Zealand; make New Zealand's tax structure internationally attractive, particularly in relation to Australia; and be fiscally responsible.

We think it is important to recognise that the rates of tax on companies and other entities cannot be considered in isolation from personal tax rates, since individuals are the ultimate owners of business entities. Personal and company tax are interrelated through the imputation system. Many businesses, such as sole traders and partnerships, including many farming operations, would not benefit from a business tax review that focused on company taxation alone.

We have based our approach on the conclusions of the government's 2001 Tax Review which advocated moves towards a lower, flatter income tax structure. This was a comprehensive and competent exercise. Like the review group, we do not see a need in present circumstances to extend the tax base or to introduce new taxes, and we do not favour selective business tax concessions. We want to see changes that would simplify the tax system and reduce business compliance costs.

Accordingly the essence of the proposal in the attached paper is to lower the company rate of tax to 25 percent and the present top and upper middle personal tax rates to 28 percent in two steps at the start of the 2007/08 and 2009/10 tax years. We see this as a substantial step towards the widely agreed goal of aligning the rates of tax on company, trustee and other income with the top personal tax rate. We also see it as consistent with the government's commitment to a 'bold' review. However, if the government is not prepared to go that far, we recommend

reducing the top personal tax rate to 33 percent and the company rate to 28 percent as an immediate step.

We believe that a move to a lower and flatter tax structure could be readily funded by a combination of existing provisions for additional spending or revenue reductions; reductions in base spending; a lower operating surplus; and the revenue benefits of the impetus to the economy of a lower tax structure. As the McLeod Review noted, the capacity for redistribution of public expenditure programmes and a less progressive tax scale would not put at risk the government's equity goals.

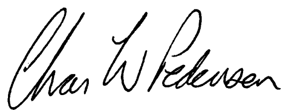
It is also our view that, given the government's major tax review in 2001, there is no need for the tax review to be protracted. Indeed decisions on the lines suggested could be announced in the 2006 Budget.

The New Zealand Institute of Chartered Accountants supports the thrust of our proposal but would prefer an alignment of lower company, trustee and top personal tax rates.

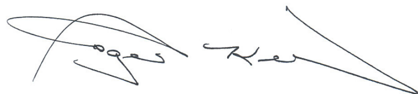
We are aware that other business organisations generally support the suggested package and we are confident that it would be widely endorsed and welcomed by the business community at large.

We hope you find this initiative constructive and we would appreciate the opportunity to discuss it with you and responsible ministers.

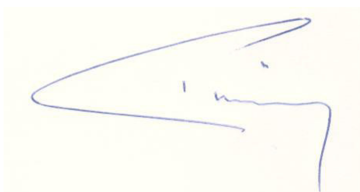
Yours sincerely



Charlie Pedersen
Federated Farmers of New Zealand (Inc)



Roger Kerr
New Zealand Business Roundtable



Charles Finny

New Zealand Chambers of Commerce (Inc)

REVIEW OF BUSINESS TAX: RECOMMENDED STRATEGY

1. Introduction

This memorandum outlines the main elements of a business tax package that is consistent with Labour's coalition agreements with New Zealand First and United Future, and recognises the broad constraints within which the business tax review is being conducted.

The package focuses on a lower and flatter tax structure funded from the existing provision for additional growth in operating spending or revenue reductions; modest savings in base spending; a lower operating balance; and the revenue benefits of the impetus to the economy of a lower tax structure.

2. Tax rates

We think that the central outcome of the review should be a reduction in the rate of company tax (and related rates of tax) and a narrower gap between the top personal and company tax rates.

We propose a company tax rate of 25 percent. The present top and upper middle personal tax rates would be reduced to 28 percent.

The changes could be introduced in two steps at the start of the 2007/08 and 2009/10 tax years (see the appendix for details).

The following factors have been taken into account in proposing the above rate structure:

- The government's commitment to raising the rate of economic growth and to a 'bold' review.

- We think the medium-term objective should be to lower the company rate of tax and the top personal rate to 25 percent, or below, in parallel with a reduction in the ratio of government spending to GDP. This would enhance efficiency and stimulate economic growth. Progress should be made toward this objective in the present parliamentary term.

- The 2001 McLeod Tax Review was a recent comprehensive and competent examination of the tax system. We see no need for a further protracted review. The McLeod Review supported a lower, flatter income tax structure and saw no need for additional taxes. It recommended a two-step personal tax scale of 18 percent and 33 percent, and a company tax rate of 33 percent. The Tax Review observed in its final report, "At these tax rates … New Zealand would be likely to remain an unattractive destination for internationally mobile capital and people" (page vii). Given changes in the fiscal position, there is more latitude for tax reductions today than in 2001.

- The coalition agreements envisage a tax system that provides better incentives for productivity gains and improved competitiveness with Australia. The reporting in Australia of 'income' generated in New Zealand points to a company tax rate that is no higher, and preferably lower, than Australia's rate of company tax. Australia's present rate is 30 percent. Australia is expected to reduce personal income tax, and could well lower its company rate over the next few years.

- Personal rates of tax – not the company rate of tax – are generally the relevant tax rates for new domestic equity-financed investment through companies and for investment by sole traders and partnerships, such as self-employed farmers, trades people and members of certain professions. A reduction in the company tax rate alone would not generally be relevant to sole traders and partnerships.

- Reductions in high effective marginal tax rates, such as the top personal rate of tax, and in taxes on capital income, are the most important from a growth perspective. Lower personal rates of tax would also help to address the high effective marginal tax rates associated with the phase-out of family and other income-related assistance.

- The principle of a lower and flatter tax structure, which acknowledges the inter-relationship between entity and personal tax rates, has substantial merit. The suggested package would constitute a significant step in that direction. The desirable goal of alignment of entity and personal tax rates, including taxation of trustee income and fringe benefit taxation, would greatly reduce administration and compliance costs and reduce tax planning.

- A broad income tax base which, as far as possible, treats particular classes of businesses and all business activities on an even-handed basis, enhances economic efficiency. Concessional tax treatment for selected businesses, categories of spending or income are unlikely to achieve the government's growth objectives. Higher productivity in all industries should be encouraged, consistent with the coalition agreements. Preferential tax treatment for some activities or classes of taxpayers would not address the business community's call for lower rates of tax.

- We do not see a need to extend the tax base or to introduce new taxes. The introduction of a payroll tax, for example, would be opposed. The economic effect of a payroll tax would be similar to an increase in GST (which we do not favour) and involve much higher compliance and administration costs. In the long run, the tax would largely be borne by labour through a reduction in post-tax wages and lower employment than otherwise. Feasible payroll taxes are problematic. Australian state payroll taxes reflect the need for an independent state tax base and do not provide a good model for central government. A move in the direction of Australia's company tax rate does not necessitate the adoption of other features of Australia's tax system. At the last election, no party advocated new taxes or higher taxes to fund a reduction in company tax.

- Lower income tax rates could be announced in the 2006 budget and implemented with the first step effective from the 2007/08 tax year (ie from 1 October 2006 for companies with 'early' balance dates). There is no need for lengthy investigations and extensive legislation. There was wide support at the last election for tax reductions.

- As suggested below, the package can be funded without introducing a new tax and without unduly increasing any inflationary pressures in the short term.

We see this proposal as consistent with the government's commitment to a 'bold' review. However, if the government is not prepared to go that far, we recommend reducing the top personal tax rate to 33 percent and the company rate to 28 percent as an immediate step.

3. Funding

On a static basis, the above tax rate changes might cost about $4.4 billion a year (2.7 percent of GDP) when fully implemented. The first step would cost around $1.75 billion while the second

step would cost an additional $2.65 billion. (These figures reflect 2006/07 income and tax data and provide a 'ballpark' estimate only.)

The total package could be financed as follows:

- allocating, say, $2 billion (about 35 percent) of the provision made in the 2006 Budget Policy Statement for additional operating spending or revenue reductions between 2007/08 and 2009/10 (inclusive);

- achieving savings of, say, $0.5 billion from lower spending or reduced tax concessions;

- reducing the forecast operating surplus by $1.9 billion, thereby funding more capital spending from debt. The ratio of the operating surplus to GDP would be around 1 percentage point lower than otherwise while the ratios of the deficit in cash available and gross debt to GDP would be about 1 percentage point higher.

It should also be noted that Treasury's ready reckoner, which was applied to estimate the static revenue cost of the package, does not take account of second-round macroeconomic effects and indirect effects on other taxes of tax cuts or increases. We agree that tax reductions are not generally self-funding over the medium term. Moreover, all tax reductions are not equal. Whether they are growth-oriented or not has a major bearing on their economic impact. It is clear, however, that well-designed tax reductions can materially increase economic growth. In those circumstances, a larger proportion of the initial revenue cost would be recovered over the medium term than is reflected in Treasury's ready reckoner. Treasury implicitly takes any such additional recovery into account when it updates its tax forecasts over time.

Some research undertaken in the United States suggests that a 10 percent reduction in income tax may increase taxable income by 4 percent. If this elasticity (net of the recovery of revenue through first-round effects which Treasury takes into account) is applied to the tax reductions proposed above, the cost of the package might be $3.3 billion or up to $1.1 billion (0.6 percent of GDP) lower than the static analysis suggests.

The level of company tax collections reflects the rate of company tax, the structure of company and other tax rates, the tax base and the performance of the economy. Company tax collections increased from 2.8 percent of GDP in 1984/85 to 5.4 percent in 2004/05. In nominal terms collections increased more than 6-fold. (In 1984/85 the company tax rate was 45 percent, it was increased to 48 percent in 1986/87, reduced to 28 percent in 1988/89 and was set at the present rate of 33 percent in 1989/90.) Australia cut its company tax rate from 36 percent in 1998 to 30 percent in 2001. Its company tax revenue is reported to have risen by over 100 percent between 1997/98 and 2004/05.

Finally, we submit that if the tax review extends beyond the lowering of tax rates, it should be examined in the context of the generic tax policy process.

Appendix

DETAILS OF SUGGESTED TAX PACKAGE

Existing tax rates	
Company rate	0.33
Top personal rate	0.39
Upper middle rate	0.33

Existing income tax brackets	$
Upper tax bracket applies over	60,000
Upper middle rate applies over	38,000

Treasury ready reckoner	
A 1 percentage point change in:	$m
Company rate	
Gross (ie if personal rate is also changed)	300
Imputation clawback	85
Net (ie if personal rate is unchanged)	215
Top rate of personal tax	130
Upper middle rate	105

Source: Treasury ready reckoner for 2006/07, December 2005

Treasury forecast of GDP	2005/06	2006/07	2007/08	2009/10
	$m	$m	$m	$m
GDP (June year)	158,947	163,062	169,897	187,853

Source: HEFU, December 2005, p 27

Proposed package	2007/08 & 2008/09	2009/10
Company rate	0.30	0.25
Top personal rate	0.35	0.28
Middle personal rate	0.30	0.28

Cost based on 2006/07 incomes	2007/08 & 2008/09		2009/10		Total package	
	Percentage Points	$m	Percentage Points	$m	Percentage Points	$m
Reduction in company tax	3	900	5	1,500	8	2,400
Reduction in top rate	4	520	7	910	11	1,430
Reduction in upper middle rate	3	315	2	210	5	525
Other nei, say		15		30		45
Total cost		1,750		2,650		4,400
Cost to GDP 2006/07 (%)		1.07		1.63		2.70

Funding - static	2007/08	2009/10	Total package
	$m	$m	$m
Reduction in growth in spending comprising 35% of new spending provision for 2007/08 to 2009/10	800	1,200	2,000
Spending reductions/efficiency enhancing tax chang	200	300	500
Reduction in surplus/higher debt financing of capex	750	1,150	1,900
Total funding	1,750	2,650	4,400

Funding - dynamic	
Fiscal cost of total package - static	4,400
Change in cost due to dynamic effects	
Personal tax	-534
Company tax	-542
Total dynamic effects	-1,075
Cost after taking account of dynamic effects	3,325
Cost to GDP 2006/07 (%)	2.04

Dynamic effects are additional to the claw back of indirect taxes taken into account by Treasury

Fiscal indicators	2007/08		Total package	
	$m	% GDP	$m	% GDP
OBERAC/operating balance HEFU	4,103	2.4	5,091	2.7
OBERAC/operating balance with package - static	3,353	2.0	3,191	1.7
OBERAC/operating balance with package - dynamic			5,916	3.1
Cash available HEFU	-2,687	-1.6	-1,366	-0.7
Cash available with package - static	-3,437	-2.0	-3,266	-1.7
Cash available with package - dynamic			-2,191	-1.2
Gross sovereign-issued debt	35,728	21.0	36,195	19.3
Gross sovereign-issued debt with package - static	36,478	21.5	38,095	20.3
Gross sovereign-issued debt with package - dynamic			37,020	19.7

Base forecasts are for relevant year but funding costs reflect 2006/07 incomes

Source: HEFU, December 2005, p 29

General notes:
Costings are 'ballpark' only
Costings depend on a number of assumptions and incomplete information
Costings are based on estimated income levels and tax revenue for 2006/07
FBT, SSCWT and tax on trustee income have not been explicitly taken into account, although an allowance for items not included has been made
Detailed calculations of the dynamic cost of the package are available on request
Excludes behavioural and transitional effects, except where noted