

NEW ZEALAND BUSINESS ROUNDTABLE

**SUBMISSION ON COST RECOVERY OF
PASSENGER AND CRAFT BORDER CLEARANCE
SERVICES**

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Summary and Conclusions

- This submission on the September 1998 inter-departmental discussion document *Cost Recovery of Border Clearance Services for Passengers and Craft* is made by the New Zealand Business Roundtable (NZBR), an organisation of chief executives of major New Zealand business firms. The purpose of the organisation is to contribute to the development of sound public policies that reflect overall New Zealand interests.
- The NZBR fully supports a policy of user charges for government-provided goods and services where purchases are voluntary, supply is subject to competition and the government chooses not to privatise the government provider. As long as supply is on a competitively neutral basis, such user charges can be thought of as a price that tracks marginal cost and reflects marginal user valuations.
- However, where the government-owned supplier is a statutory monopoly, there is no competitive discipline on the cost of supply. Government ownership will also weaken, if not eliminate, the incentive to minimise costs. The combination of the absence of competitive disciplines and the bureaucratic incentives to expand activities reduces the efficiency gains that might otherwise be obtainable from user charges. In particular, there is a risk that services will be inferior and excessively costly. Credible checks and balances on any charges are required in order to prevent the abuse of a dominant position.
- In the case of public goods, users who do not pay any charge can, by definition, still benefit from the service. Publicly provided public goods must be funded by mandatory charges or taxes. These may be set at levels that fail to reflect either supply cost or user valuations of benefit. Any taxes should be evaluated in terms of their conformity with sound tax policy principles.
- In the case of so-called 'club' goods, people who do not pay an access fee can be excluded from the benefits offered by the facility, but once access is obtained the marginal cost of use may be low or even zero. Club goods are therefore an intermediate case between a private and a public good. The optimal funding of private, club and public goods is discussed in section 2.
- Border protection services are a public good. The policing of laws and regulations is a public good activity, the benefits of which accrue generally. Fines imposed on wrong-doers help fund enforcement costs. Where the provision of a public good benefits the population as a whole, remaining financial requirements should be funded from general taxation. Indeed, as noted

in section 2, the proposed mandatory charges have the characteristic of a tax rather than a price. Taxes tend to be characterised by compulsion and by the absence of any close link between benefit and impost.

- Section 3 addresses the 'source of risk' and avoidable cost arguments to the effect that the proposed charges are a user fee and not a tax because border protection services allegedly benefit travellers and importers rather than pest-sensitive industries or the public at large. The discussion concludes that these propositions provide no stable or reliable basis for public policy. Both depend on arbitrary assignments of liability and neither demonstrates that the cost of border protection services represents the optimal charge in relation to any given assignment of risk.
- The discussion concludes that the assignment of liability in respect of the regulation of risk, and the payment of any compensation for any takings of property rights in making such an assignment, are separate from the issue of the subsequent optimal enforcement of property rights.
- Providers of tourism services and of sea and airport facilities do not benefit more than the public at large from an extra dollar spent on policing the borders. Nor do they have any superior information about the marginal benefits that accrue to pest-vulnerable industries as a result of an extra dollar spent on border protection.
- The fact of compulsion and the absence of a link between benefit and the quantum of payment justify the conclusion that the proposed border charges are a tax and not a price. We therefore turn, in section 4, to consideration of the optimality of the charges in terms of sound tax principles concerning constitutionality, equity, efficiency and conformity with due process.
- On the constitutionality aspect, the submission notes legal views that the proposed charges may conflict with New Zealand's obligations under international law. We are also concerned in this context that, as a matter of principle, adequate safeguards must be put in place when the power to tax is delegated. We do not believe that this is currently the case.
- From an equity perspective, we note that the tax appears to be highly discriminatory. This is because those liable for the tax do not receive any service that they can be expected to value more than any other law-abiding citizen. It is a gross misnomer to call this tax a *user* charge. Nor can the proposed charges be thought of as a penalty for illegal behaviour. The vast majority of those who are liable for the proposed charges are unlikely to be in breach of any law. Injunctions, fines, imprisonment or tort actions provide more appropriate sanctions for those who might or do breach the law.
- On the efficiency aspect, the submission rejects the claim that the proposed charges represent an efficient way of harnessing any information ports have about the performance of border protection activities. To the contrary, we concur

with the view that the proposals invite bureaucratic expansion and excessive border protection costs. There is a risk that they could increase bureaucratic tendencies to adopt a high cost, low risk enforcement strategy.

- Although it is an empirical matter, the NZBR shares the concerns of some in the travel industry that would-be foreign visitors and exporters could respond quite significantly to attempts to shift the burden of New Zealand taxes on to foreigners. Propositions that there is a 'free lunch' in taxing foreigners need to be closely argued rather than loosely asserted.
- Another efficiency concern is that the proposed charges have the character of a tied tax. Tied taxes can lead to excessive spending on the activity to which revenues are tied.
- Finally, in respect of conformity with sound tax policy processes, the proposed charges do not appear to accord with the requirements of the Generic Tax Policy Process. In particular, this sets out procedures that should be followed prior to the enactment of tax legislation and for systematic review after it has been passed. The date for this review must be set prior to the adoption of legislation by parliament. Given the controversial nature of the propositions about elasticity of response and industry complaints about the level of charges, such a provision is highly desirable.
- In short, the proposed charges appear to be deficient from a tax policy perspective in all major respects. The proposal to recover 100 percent of border protection costs from a target group which obviously does not benefit can only indicate that the policy framework is seriously deficient. There appear to be no sound grounds for departing from a policy of sensibly scaled fines for transgressors and taxpayer funding of a level of enforcement of border laws that parliament deems to be optimal.
- In the NZBR's view, the current proposals indicate that the government does not have a sound policy framework for addressing user charge issues in the context of mandatory services of a public good nature supplied by a statutory monopoly. The current proposals should be put on hold until the current framework is thoroughly reviewed.

1 Introduction

- 1.1 This submission on the September 1998 inter-departmental discussion document *Cost Recovery of Border Clearance Services for Passengers and Craft* is made by the New Zealand Business Roundtable (NZBR), an organisation of chief executives

of major New Zealand business firms.¹ The purpose of the organisation is to contribute to the development of sound public policies that reflect overall New Zealand interests.

- 1.2 In recent years, public policy has arguably failed to distinguish adequately between desirable user charges and undesirable discriminatory taxation. Reflecting these concerns, the NZBR and the New Zealand Food & Beverage Exporters' Council commissioned Credit Suisse First Boston to prepare a report on these issues in 1997. Credit Suisse First Boston's (CSFB's) July 1998 report, *Regulation of the Food and Beverage Industry*, a copy of which is enclosed, discussed many of the analytical issues involved in user charges. This submission applies the framework developed in that report to the funding of border protection costs.
- 1.3 The NZBR strongly supports user charges that are likely to improve economic efficiency. User charges that track marginal cost and reflect user valuations have desirable efficiency attributes. They are likely to be most efficacious in this respect when supply is competitive, purchasing is voluntary and the commodity being supplied has the characteristic of a private good.
- 1.4 However, when user charges are mandatory and do not closely reflect user valuations, they take on the characteristic of a tax rather than a market clearing price. The case for viewing a proposed mandatory user fee as a tax is heightened when the good or service is a public good and is being provided by a statutory monopoly. So-called 'club' goods are an intermediate case. Section 2 discusses the optimal funding of private, club and public goods. It also argues that many border protection services have the attributes of a public good.
- 1.5 Disputes, if not confusion, over who benefits from a government-supplied service have been a feature of debates over user charge policies. A regulation may aim to stop one group or activity from harming another group or activity, or from putting that second group or activity at risk. Who benefits from that regulation? One view is that the regulation benefits the group or activity that would otherwise be put at risk. The counter view is that the regulation effectively permits members of the first group to go about their affairs to a degree that would not be permissible but for the existence of the regulation. Government agencies that are under pressure to impose 'user charges' and keen to maintain their scale of operations will naturally propose to recover their costs from the most administratively and politically convenient group or activity. They may seek to justify their proposal against the criticism that it is a discriminatory and unwarranted tax by opportunistically citing whichever of these contesting views best supports the case for a user fee. Clearly there is a need for a principled and consistent approach to the question of whether the

¹ *Cost recovery of Border Clearance Services for Passengers and Craft*, September 1998, Discussion Document, Ministry of Agriculture and Forestry, New Zealand Customs Service and New Zealand Immigration Service, pp 1-47.

application and quantum of any user charge reflects the benefits derived from those on whom the cost is imposed. This issue is discussed in section 3.

- 1.6 Section 4 discusses the issue of how to assess user fees that are best described as taxes. The merits of any proposed taxes should be assessed in terms of their constitutionality, equity and consistency with optimal tax (efficiency) principles.
- 1.7 For convenience, the appendix lists five arguments that have been put forward for recovering costs via the proposed discriminatory charges, indicates the sections of this submission in which four of them have been addressed and briefly comments on the fifth argument.

2 User charges for publicly provided private, club and public goods

Definitions and concepts

- 2.1 User fees potentially have a useful role to play in promoting efficient resource use by confronting users with the costs their demands would impose at the margin on society. The efficiency of a user charge to recover costs depends on whether it is the most efficient way of inducing the production of the socially optimal amount of the underlying good or service.² As defined, a user fee is a price that might either aim to recover a user-induced cost of supply or to correct a market failure. It is the former aspect that is relevant to the border protection proposal discussed in this section.
- 2.2 The MIT Dictionary of Economics³ explains that the price of a good or input signals what has to be given up in order to obtain a good or service. From a societal point of view, what has to be given up if that good or input is supplied is the opportunity cost of the supply of that good or input.
- 2.3 Charges that track the marginal cost of supply force fee-paying users to consider at the margin whether the benefit they hope to derive is commensurate with this cost of supply. As long as potential purchasers can avoid the charge by going without, the user charge deters a welfare-reducing supply if the prospective purchaser deems the benefit from the service to be less than the costs of supply. In this environment, user fees are a price and can be interpreted as reflecting a balance between marginal benefit and marginal cost.
- 2.4 Fundamental to this case that user charges improve efficiency are the assumptions that:

² See p 801 in "Federal User Fees: A Legal and Economic Analysis", Clayton Gillette and Thomas Hopkins, *Boston University Law Review*, Vol 67:795, pp 795-874, 1987.

³ *MIT Dictionary of Modern Economics*, 4th edition, p 340.

- the commodity being sold is a private good;
- purchase is voluntary;
- competition creates pressures to supply at minimum cost;
- price reflects the marginal benefit to the purchaser and to society; and
- price reflects the opportunity cost of supply – eg social marginal cost.⁴

2.5 However, as a matter of best practice, private goods should be supplied privately and competitively. User charges only have a useful potential role to play where a government agency provides the private good nonetheless. Where a Crown-owned entity is supplying private goods it should be exposed to competition from private providers and, to the greatest feasible extent, full commercial disciplines in respect of pricing, cost control and cost recovery. There is no case for making the purchase of a private good mandatory.

2.6 A public good is the polar opposite of a private good. In its strictest form, there is no way of charging those who benefit from a public good because it is too costly to exclude those who benefit but do not pay.⁵ Virtually by definition, the funding of publicly provided public goods is a tax issue.

2.7 Gillette and Hopkins⁶ usefully distinguish between a user charge and a tax as follows:

A user fee is a price charged by a governmental agency for a service or product whose distribution it controls. A user fee is, at least in theory, a benefit-based source of revenue whose logic is simple. Payment of a user fee reflects receipt of a valued service By contrast, federal income taxation is generally not benefit-based: rather, it imposes burdens that reflect complex Congressional judgments about, among other things, a taxpayer's ability to pay.

2.8 In similar vein, the NZIER's August 1998 report for the Ministry of Agriculture and Fisheries on cost recovery issues defined a tax as:

⁴ But note that privatising supply is likely to be superior to the imposition of a user-pays policy in such cases.

⁵ In many cases, public goods can be provided privately because they can be funded by charging commensurately more for bundled private goods. Thus supermarkets do not charge their customers directly for the use of supermarket carparks.

⁶ *Op cit*, p 800.

... compulsory unrequited payments to government – unrequited meaning that the benefits are not normally in proportion to benefits.⁷

Based on such definitions,⁸ taxes are associated with compulsion and the inability to relate the size of the impost to the magnitude of the benefit received by the person liable to pay the tax. Conversely, user fees are characterised by being discernibly related to the value to the payer, or the cost of supply, where the payer is the beneficiary and can choose whether or not to 'buy' and so incur the charge. (Part costs apply where only part of the benefit accrues to the payers.)

- 2.9 Club goods are an intermediate case. Unlike the case of a public good, with a club good those who do not pay for access to the club's facilities can be excluded. Motorised use of the public roads is a case in point. However, as long as there is excess capacity, a club good may share the public good characteristic that the use of its facilities by any one member does not detract from the ability of any other member simultaneously to enjoy those facilities. Uncongested golf courses, cinemas and roads are examples of club goods.
- 2.10 The public provision of a club good permits, again by definition, the possibility of charging those who wish to benefit from the service. The CSFB report finds that it is desirable to charge those using such services directly:

... since the annual access or membership charge is part of the test that members are prepared to fund the total cost of the activity.

However, the case for charging members of any group or club the opportunity cost of the facilities provided is stronger the greater their ability to determine the level of service and the amount of the charge.

- 2.11 Road-user charges, petrol taxes and motor vehicle licence fees currently suffice to more than fully fund the cash expenditures of the suppliers of road infrastructure services. It is not compulsory to buy a vehicle that is subject to petrol tax or road-user charges. There is therefore a valid efficiency argument for confronting such road users with charges that reflect use-related costs of supply. (These include the costs of increasing future capacity and justifiable maintenance of existing roads.) However, as the experience with petrol tax in particular indicates, the

⁷ See NZIER, *Cost Recovery of Passenger & Craft Border Clearance Services: An Economic Analysis of Funding Options*, report to the Ministry of Agriculture and Forestry by Mary Clarke with assistance from Stephen Gale, August 1998, p 1.

⁸ E M Middlemass, *Government Charges: A Study of Charging for Goods and Services in the New Zealand Public Service*, September 1991, pp 1-68, cites, at paragraph 5.2, a 1985 judgment by the High Court of Australia to similar effect.

actual charges imposed when there is a statutory monopoly may have a general revenue element. Optimal tax issues can arise even when purchase is not mandatory.

- 2.12 The hoped-for efficiency gains are likely to be reduced, and may disappear entirely, if the charge does not track marginal cost efficiently or is mandatory. Confidence that user charges will track costs appropriately is greatest when supply is competitive, the commodity is a private good and purchasing is voluntary. The less competitive are supply conditions, the less confidence there can be that user fees will track marginal cost optimally.
- 2.13 On the supply side, the relationship between user fees and marginal cost may be especially problematic when the supplier is a statutory monopoly. Charges could be too low where users have been able to achieve undue political influence over the fee-setting process. Conversely, charges could be too high in any one of three distinct cases. First, a profit-maximising statutory monopoly might set price to equal marginal revenue, not marginal cost. Second, a regulated statutory monopoly or industry (whether or not government-owned) may operate in a cost-plus manner, so that user-fees are too high because costs are too high. Third, a government may set user charges above the costs of supply for general revenue purposes – as appears to be the case in respect of fuel excise duties.

Application to border protection services

- 2.14 The provision of border protection services is clearly a public good. Those who benefit from keeping out undesirable aliens, pests or diseases cannot be excluded from the benefits should they refuse to contribute to the costs of border protection, nor does the benefit they derive detract from the benefits derivable by others. Unlike the case of those who want to drive on the roads, those who wish to benefit from border protection services do not need to join a 'club' in order to benefit – except the club comprising all residents of New Zealand and perhaps many investors in New Zealand. This is the *prima facie* case for funding the costs of border protection from general taxation.
- 2.15 A property right enforcement perspective supports the proposition that the provision of border protection services is a public good that should be funded from general taxation. Government border protection rules essentially define citizens' property rights in relation to undesirable non-residents and the importation of undesired pests and diseases. The enforcement of property rights is a crucial obligation of good government. All citizens and investors in New Zealand benefit from well-enforced property rights and none can be excluded from these benefits.
- 2.16 The proposed border charges have the following features:

- payment is compulsory;
- those who pay and their customers do not receive a service they desire;
- the virtue of the price mechanism for revealing user valuations of the benefits of more or less enforcement is absent;
- supply is a statutory monopoly;
- there is no competition to create pressures to minimise costs; and
- the policy of 100 percent cost recovery requires arbitrary allocations of common costs. These violate efficient pricing principles and the concept of marginal cost.

2.17 Given these features, the proposed border charges raise concerns on both the supply and demand sides. They suggest strongly that the proposed charges are a tax rather than a price. Those who would still defend them as a price must make the case that those entering New Zealand or bringing goods into New Zealand receive a benefit from border protection services that is commensurate with their cost. This issue is discussed further in section 3.

3 Who benefits from border protection services?

- 3.1 As argued in section 2, the basic enforcement of existing property rights, laws and regulations is a public good. The benefits are widely dispersed and accrue to some degree to all law-abiding citizens.
- 3.2 Where a new law or regulation constrains someone's existing property rights or personal freedoms in order to benefit another group, it is possible to say that the second group is a beneficiary of the new law or regulation. In these circumstances there may be a case for requiring the beneficiaries to compensate the first group for the taking. However, such 'one-off' benefits derived from a new law or regulation are different from the benefits derived from the subsequent policing of the law or regulation. There is no reason to believe that the amount of 'one-off' compensation payable by the beneficiaries of regulation or of legislation on its enactment should be closely related to the subsequent amounts the authorities wish to spend policing the new laws or regulations.
- 3.3 Once the new law or regulation is in place and the compensation issue has been decided, it is for the government to determine the optimal level of enforcement of its laws or regulations from a public good (law and order) perspective. Individuals or groups can top-up the publicly provided level of security with their own security measures.

Source of risk

- 3.4 The 'source of risk' argument that the costs of enforcing property rights should fall on an activity that is a source of risk for another activity simply begs two questions. The first is why the costs of enforcing property rights should be regarded as the correct amount to charge the risk-creating activity if the goal is to reduce the level of risk to an optimal level. That cost is not closely related to the potential losses from undesired visitors, pests or diseases. The second is why the pest-vulnerable activities should be given a preferred status in respect of the apportionment of policing costs. The alternative would be to regard those investing in vulnerable activities as reducing the potential benefits to the community from freer international travel and trade. Under this view ports should be paid for costs incurred in serving the interests of pest-vulnerable activities and the general public interest.
- 3.5 It is important to note that law-abiding visitors and importers are not sources of risk if they observe New Zealand's laws in respect of border protection. (Of course, it is appropriate to fund the costs of border protection in part from fines on those who fail to observe New Zealand's laws.)
- 3.6 In general, law-abiding citizens are not liable for the costs of lawfully exercising any rights they enjoy because others might seize the opportunity created by an activity to break the law. Thus freedom of assembly and speech are protected. Similarly, the Rugby Union and the promoters of rock concerts are not charged for the level of policing the New Zealand Police chooses to provide in its role of protecting law and order.
- 3.7 In short, the 'sources of risk' argument is fundamentally incompatible with the exercise of freedom of assembly, freedom of speech, and the legal exercise of property rights.

Avoidable costs

- 3.8 The 'avoidable cost' doctrine seeks to recover from an industry the costs of policing an industry's activities that would be avoided if the industry did not exist. This argument was discussed critically and extensively in the CSFB report, particularly in the chapters discussing cost recovery in respect of biosecurity and fisheries.
- 3.9 As applied in the case of fisheries and ports, the argument appears to be based on the view that the government would not be incurring the costs of policing the seas and ports if commercial fishing, travel or importing activities did not exist. It appears to imply that everything can be prohibited or banned without cost unless those wishing to exercise their property rights or freedom to travel pay an impost to the government of the government's choosing. According to this view,

the benefit derived from the payment of the fee is the freedom to enjoy whatever remaining property rights and liberties are left to the individuals concerned.

- 3.10 The proposition that a developer benefits from the costs incurred in ensuring that a proposed development satisfies objections raised by planners, competitors, environmentalists and other parties representing opposing interests seems to be similar in kind to the avoidable cost proposition. According to Gillette and Hopkins, for many years the Food and Drug Administration in the United States staunchly resisted pressure from the Office of Management and Budget to impose user charges on applicants for new drug approvals. Its opposition was based in part on the grounds that these activities were designed to protect the general public from impure or ineffective products.⁹ However it has since dramatically reversed its position and now reportedly takes the view that:

... any activity – and review of applications for new drug approvals in particular – performed in order to permit a regulatee to satisfy statutory prerequisites constitutes a sufficient benefit to permit imposition of a user fee¹⁰

Gillette and Hopkins report that this view is consistent with the dominant definition of benefit throughout federal agencies.

- 3.11 Clearly, like the 'sources of risk' approach, the avoidable cost proposition denies the sort of rights that are embodied in the Bill of Rights.¹¹ We are also aware of a case that the proposed border charges might breach New Zealand's obligations under international law.¹² A government that takes the view that it has the unfettered right to close down an activity or prohibit overseas travel without compensation unless a tax is paid can be compared to an extortionist who makes a "your money or your life" demand of a victim. Under the avoidable cost argument the victim who pays benefits from the extortionist's service of permitting him or her to live. Like theft, extortion by citizens is an offence because it is destructive of incentives to create wealth. Governments need to constrain themselves, or be constrained, from making arbitrary and excessive tax demands for the same reason. The avoidable cost and 'source of risk' arguments lend themselves to predatory and discriminatory taxation because of their

⁹ *Op cit*, pp 851-853.

¹⁰ *Op cit*, p 852.

¹¹ Travel Industry Coalition, *Submission to the Social Services Select Committee on the Immigration Amendment Bill 1998*, November 1998, prepared by Chen & Palmer, provides a detailed analysis of possible breaches of the Bill of Rights Act 1990.

¹² Refer for example to p 3 in the March 1998 *Submission Opposing Cost Recovery for Border Controls* to the Ministry of Agriculture presented by 26 sea ports, airports, and aviation, travel, transport and tourism representatives, councils or associations.

unconstrained nature. They thereby illustrate the importance of a disciplined and principled approach to tax issues.

- 3.12 Another objection is that even if the avoidable cost doctrine did not violate the Bill of Rights and international law, its assignment of property rights is arbitrary. As with the 'source of risk' case just discussed, an alternative view would be that New Zealanders have a right to freedom of movement across the national border, to sell tourism services and to export and import. The benefits of any constraints imposed on those rights would accrue to those who wish to have them constrained. Under this equally extreme counter view, New Zealand could avoid the costs of much border protection by closing pest-susceptible industries or by relaxing restrictions against the importation of undesirable visitors of all types.
- 3.13 Finally, the logic of the avoidable cost regime would require the government to determine what costs New Zealand would incur if international travel and trade were prohibited. Given New Zealand's dependence on land-based exports, the question is too ludicrous to pursue except to note that the logic of the avoidable cost doctrine requires cost recovery only in respect of the difference between the costs of policing the existing industry or activity and the costs of policing a ban on the industry or activity.
- 3.14 As this discussion illustrates, the avoidable cost concept fails entirely to consider the question of the optimal level of border protection services. The starting point for such an investigation is to determine the marginal benefit of an extra dollar spent on border protection services. The avoidable cost doctrine ignores marginal costs and makes no attempt to discover marginal benefit.

Concluding comments

- 3.15 The 'source of risk' and avoidable cost arguments for recovering enforcement costs from particular groups appear to be arbitrary in their assignment of liability and unsound in their assessment of the cost to be imposed. As such, these arguments provide no stable or reliable basis for public policy decisions. They appear to be silent on the question of the marginal benefit from an extra dollar spent on enforcement. Propositions about who originally benefited from a given regulation do not throw any light on the question of the quantum of benefit derivable from an extra dollar spent on enforcement of that regulation.
- 3.16 The only sound approach would appear to be to treat the issues of the regulation of risk and of compensation for restrictions on property rights or liberty separately from the issue of the optimal funding of the enforcement of property rights. Once property rights in respect of risk are assigned, the public enforcement of those rights is a public good activity.

- 3.17 If the proposed charges for enforcing property rights are seen as a user fee, this must be justified on the grounds that it brings a better balance between the resources devoted at the margin to enforcement and the benefits of enforcement. But those on whom these fees are to be levied cannot be expected to know how much benefit from an extra dollar spent on enforcement of border protection laws will accrue either to vulnerable industries or in the form of greater respect for law and order. The absence of any cogent argument that travellers, tourism operators or those engaged in exporting or importing derive any benefit from an extra dollar spent on policing border regulation leads to the issue of the optimal recovery of border protection costs through taxation.

4 Do the proposed charges conform with sound tax principles?

- 4.1 Sound taxes are constitutional, respect minority rights, conform with the rule of law and reasonable concepts of equity, and have desirable efficiency attributes. All practicable taxes distort behaviour in undesired ways. The costs of these distortions are known as the deadweight costs of taxation. Optimal tax theory is concerned with raising the revenue the government requires at minimum social cost.
- 4.2 The proposed border charges, being based on 100 percent recovery of cost, take the form of a tied tax. Tied taxes may usefully confront users of a club good with the replacement costs of the club's facilities, but they may also sanction inefficient cost-plus behaviour, reduce the flexibility of the government to allocate funding to the highest priority areas and lead to inefficient investment in the tied facility.
- 4.3 In this case the revenues from the proposed charges are not being used to fund the provision of a club good. Nor is payment voluntary. Nor is the level of service being determined by those who desire to be members of a club. These features increase the risk that the tied element of the proposed taxes will increase their cost.

Constitutionality and the rule of law

- 4.4 As noted in section 3, we are aware that serious legal questions have been raised about the constitutionality of the proposed charges in terms of international law and the Bill of Rights Act 1990. Regardless of the resolution of these arguments, the NZBR sees it as important for the rule of law that parliament should take a very conservative approach to requests from the executive that it delegate its power to tax. Adequate safeguards against the abuse of delegated powers to tax are essential. The incentives on administrative bodies to use any *de facto* powers to tax to expand their budgets and their influence are obvious. The Travel Industry Coalition's November 1998 submission cited above pointed to a disturbing lack of safeguards in the Immigration Amendment Bill 1998. For

example, any charges would not be subject to scrutiny by the Regulations Review Committee.

Equity

- 4.5 It is grossly inequitable that one group of law-abiding taxpayers or taxpaying entities be taxed in order to police regulations or laws that are clearly designed to assist other industries and the wider public interest. The proposed tax is not to be imposed, for example, on owners of livestock, plants and trees who benefit commercially from the enforcement of rules designed to keep out unwanted pests and diseases. Nor is any case made that the implied wealth transfers have favourable effects on the distribution of income.

Efficiency – shifting the burden to foreigners

- 4.6 Optimal taxes seek to raise revenue at lowest cost. The basic theory of optimal taxation posits an 'in principle' efficiency case for taxing most heavily those products for which demand is most insensitive to the tax-inclusive price. In practice, New Zealand's general approach has been to stress the unreliability of estimates of price elasticities and to opt for uniform indirect taxes so as to minimise administrative and compliance costs.
- 4.7 New Zealand's size and the fact that foreign travellers and exporters have access to the rest of the world for their trips and goods respectively suggests that the demand by foreigners for New Zealand's border control services could be quite price sensitive. The suggestion by the industry that the proposed charges could stop visits by some cruise ships illustrates this point. In respect of the taxation of foreign investment in New Zealand¹³ and the use of import tariffs, policy makers have generally taken the view that the costs of attempting to tax foreigners outweigh any possible benefits. The same arguments appear to apply in respect of foreign migrants and visitors.
- 4.8 Even if foreign demand is elastic, it is possible that the distortions arising from the proposed taxes could be small if New Zealanders involved in importing, exporting and tourism absorb the full amount of any charges at an unchanged volume of activity. While this is an empirical question, the proposition does not seem obviously plausible and it appears to be inconsistent with the GST regime that does not seek to penalise international trade relative to domestic trade.
- 4.9 To conclude, any proposition that taxing foreigners provides a 'free lunch' needs to be cogently argued rather than loosely asserted. This is not to argue, of course, against user-pays charges for non-mandatory private goods supplied to foreigners.

¹³ The particular case of double tax agreements is an exception.

Efficiency – incentives to scrutinise costs

- 4.10 Another efficiency argument for the proposed charges is that they would create an incentive to scrutinise the costs of border protection. Those involved in transporting people and goods to New Zealand allegedly have information about actual border protection levels, quality of service and cost efficiency that is superior to that enjoyed by those currently responsible for monitoring these expenditures and advising the minister of finance, cabinet and parliament about the optimal level of funding for government services.
- 4.11 However, the fact that information is undoubtedly widely dispersed does not come remotely close to creating an argument for 100 percent cost recovery from those whose information is superior in *some* respects to that of those who are responsible for setting budgets. One might equally argue that criminals and the victims of crime are better placed than the general public to assess how well the police are doing their jobs so that the costs of policing in any one year should fall on those who were charged with a crime or the victims of a crime in that year. Similarly, by the same argument, school teachers should bear the full costs of each others' salaries, because each teacher has superior information to the Treasury about their colleague's performance.
- 4.12 There is no need for the government to use coercive powers of taxation to purchase information that others possess by virtue of their investment in a business activity. If the government desires to collect widely dispersed information it can pay people to collect and provide it.
- 4.13 Furthermore, what is far more important than providing those with information with an incentive to complain is the need to incentivise those responsible for regulating and policing border activities to relate the costs of regulations to the benefits. Under current arrangements there is a risk that the incentives of Treasury, the minister of finance and parliament to closely scrutinise the benefits derived from expenditures on border protection will be reduced if the expenditures are 'self-funding' by a tied tax. The government's proposal to fund the ACC 'tail' by what amounts to a payroll tax does not appear to accord with sound principles and only heightens the NZBR's concerns about the role expediency could play in the scrutiny of expenditures that do not put pressure on general rates of tax. Those benefiting from the services will have a reduced incentive to relate benefits to costs and those providing the services will have all the normal bureaucratic incentives to inflate costs by adopting a low risk approach. Far from improving incentives where it is important to do so, the proposals would appear to weaken all incentives to relate benefits to costs.

Conformity with tax policy processes

- 4.14 Procedurally, it is desirable that all proposed taxes should be subject to the scrutiny of the Generic Tax Policy Process. This has not occurred and the

proposed regime does not appear to conform with sound tax principles in respect of constitutionality, equity and efficiency, or with government process requirements.

Appendix Arguments in support of the 'user-charge' proposals

A.1 Five arguments appear to have been advanced in support of the 'user-charge' proposals:

- (1) they create an *incentive to scrutinise the costs* of border protection;¹⁴
- (2) *sources of risk* should be made to pay for the risk they impose;¹⁵
- (3) those whose activities impose otherwise *avoidable costs* should be confronted with those costs;¹⁶
- (4) charging port companies will *shift the burden* of bearing border protection costs from New Zealand taxpayers to foreign sources of risk;¹⁷ and
- (5) *fiscally* the proposals are useful because they would 'improve' the government's reported operating balance and its ability to reduce income tax rates.

A.2 Arguments (1) and (4) are discussed in section 4 (paragraphs 4.10-4.14 and 4.6-4.9 respectively). Arguments (2) and (3) are discussed in section 3 (paragraphs 3.4-3.6 and 3.7-3.13 respectively). Argument (5) is discussed below.

Fiscal Effects

A.3 There is no national interest case for imposing an inefficient tax in order to fund additional spending or to reduce an efficient tax. The argument that there are advantages in off-budget funding of expenditures is not a national interest argument. To the contrary, the government's decision to fund the ACC 'tail' by way of a payroll tax illustrates the tendency of governments to find expedient and unsound ways of reducing pressures on income tax rates.

¹⁴ Refer, for example, to p 8 of the discussion document.

¹⁵ NZIER report, p ii.

¹⁶ *op cit*, p ii.

¹⁷ *op cit*, p iii.