NEW ZEALAND BUSINESS ROUNDTABLE

SUBMISSION ON THE TAX REVIEW 2001

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EXECUTIVE SUMMARY

The Tax Review is a welcome development

The New Zealand Business Roundtable (NZBR) welcomes the opportunity to make this submission to the Tax Review 2001 (the Review).

The level of government spending

The primary purpose of the tax system is to finance government expenditure. The level of government spending generally provides the best overall measure of the tax burden. The Review should therefore focus, in the first instance, on the level of government expenditure that might properly be funded from taxation over the medium to longer term.

We believe that a principled analysis of the role of the government, against the background of policies aimed at increasing the rate of economic growth and firm fiscal discipline, would conclude that a substantially lower level of government spending is required in the future.

Principles for tax policy

The terms of reference require the Review to identify the principles that should guide tax policy development, and to apply those principles to evaluate the current tax system and identify and assess alternative options for reform.

The key conclusions presented in this submission are summarised below:

- **Expenditure reform is a crucial prerequisite for further tax reform.** New Zealand's sustainable economic growth rate is probably in the range of 2 - 3 percent. This is an improvement on the economy's growth capacity prior to the economic reforms of the 1980s and the early 1990s. Nevertheless, such a rate is insufficient to raise living standards relative to other Organisation for Economic Development and Cooperation (OECD) countries and highlights the need to increase economic efficiency, output and incomes. Although further changes to the structure of the tax system may improve economic efficiency to some extent, the government will not be able to do much to reduce the economic costs of taxation without significant reductions in its share of national income. Actual spending reductions coupled with actions to constrain annual increases in spending to below the growth rate of the economy are the key to achieving a lower tax burden. Expenditure decisions need to be made with regard for the economic costs of raising the revenue required to finance that expenditure. Projects financed from tax revenue have to generate rates of return well in excess of normal business rates of return to cover the high costs of raising tax revenue.

- **Need for the government to focus on its core activities.** In order to improve national welfare and the country's prospects for increased growth and employment, it is essential for the government to focus its attention on the provision or funding of core or essential public goods and a social safety net - which includes underwriting access by those on low incomes to services such as health and education - and to discontinue expenditure on non-core activities. We believe this would enable total government spending (central plus local) to be reduced over time to below 20 percent of gross domestic product (GDP). It would also enable the government to increase the quality of the core services it provides. The government should establish a goal under the Fiscal Responsibility Act 1994 of reducing central government spending to 30 percent of GDP or below over the next few years, as a step towards a lower target. Some of this reduction could be achieved by holding the rate of growth of government spending to below the growth rate of the economy.

- **Substantial improvements were made to the tax system between 1984 and 1999.** The guiding criteria were efficiency and equity. They were reflected in the adoption of two broad tax bases (income and consumption spending) and moves toward lower and more uniform rates of tax. The rates of personal and company tax were lowered. The income tax base has been broadened, for instance by the elimination of many concessions, by taxing fringe benefits and by the introduction of the accrual rules. The introduction of GST allowed the highly distortionary wholesale sales tax and certain other indirect taxes to be abolished or reduced. The reforms followed closely those advocated by organisations such as the OECD and were broadly consistent with policies adopted by other developed countries. While there may be grounds for finetuning the policies generally adopted between

1984 and 1999 and building upon them, there are no principled reasons for abandoning them.

- **The economic cost of raising and redistributing marginal revenue via the tax and benefit systems is high and probably increasing.** Most tax rates are lower and more uniform than they were in 1984, and the income and consumption tax bases are now much broader. However, the ratio of tax revenue to GDP has increased by 10 percent from 30 percent in 1984/85 to 33 percent in 2000/01. In addition, decisions affecting the use of resources are now more sensitive to taxes due to deregulation, lower barriers to international trade and the increasing mobility of capital and labour. As a result, the deadweight costs of raising tax revenue are increasing. The cost of raising an additional dollar of tax revenue is now probably well in excess of $1.30.

- **Lower and more uniform rates of tax are essential.** If the government is serious about reducing disincentives to save and invest, improving the quality of investment, increasing New Zealand's ability to attract and retain skilled labour, and enhancing New Zealand's prospects for increased growth and employment, it should adopt lower and more uniform tax rates geared to financing a lower level of government spending (relative to GDP). Since the deadweight costs of raising tax revenue rise more than proportionately as the rate of tax increases, a reduction in high effective marginal rates of tax (including the top personal tax rate) is likely to produce the greatest reduction in those costs. In parallel with a reduction in the government spending ratio, the top personal tax rate and the company tax rate should be reduced to within the 25 - 30 percent range as rapidly as possible as a first step.

- **There is limited scope for further improvements in the structure of the tax system.** Further structural reforms, such as the introduction of new tax bases, are unlikely to be justified on efficiency or equity grounds. After almost two decades of tax reform, the New Zealand tax system is widely regarded as one of the best in the world. The scope for taxing a wider range of income from capital efficiently is limited by the problems associated with accurately measuring asset values. Tax-induced variations such as a bias towards investment in residential housing are best addressed by reducing tax rates. The scope for raising revenue by so-called 'green' taxes is limited by practical problems associated with obtaining the information required to set such 'optimal' taxes. Policies such as lower spending and taxes, and more uniform rates of tax, are more likely to advance valid environmental objectives because they provide incentives to reduce waste and to innovate, and they spur growth. High-income countries devote considerably more resources to environmental purposes than poor countries.

- **Selective tax concessions are not the answer.** Selective tax concessions erode the tax base, requiring higher rates of tax to be imposed on other activities, and reduce the overall quality of investment. They also encourage lobbying by other taxpayers that leads to further erosion of the tax base. Selective tax concessions are horizontally inequitable because people with the same incomes pay different amounts of tax.

What principles should guide tax policy development?

- **All government policy initiatives, including new tax policies, should be assessed from the point of view of their likely impact on overall national welfare.** The fundamental principle is to ensure that any proposed initiative will improve national welfare to the greatest possible extent.

- **When determining the role of the tax system, the government should apply the same broad set of principles that it uses to determine the role of each of its policy instruments.** Specifically, it should use an 'integrated' approach to policy development, as is embodied in the strategic phase of the generic tax policy process, to identify its broad policy objectives and determine which of the wide range of instruments at its disposal is most suited to achieving them. In addition, before intervening in the economy using either the tax system or any other policy instrument, it is important to:

  – determine the nature and extent of the problem and the need for government intervention;

  - set clearly defined and realistic objectives;

  - identify and evaluate the merits of alternative policy instruments and options, including the option of taking no action; and

– establish whether the proposed intervention will produce a net benefit for New Zealand.

These broad principles are requirements of the Regulatory Impact Statements that must accompany regulatory proposals submitted to Cabinet.

- **When reviewing and reforming the current tax system, the government should:**

Assess the current tax system and any proposed tax reform initiatives against the following criteria:

– efficiency - that is, the tax system should be capable of performing its role in a manner that imposes the lowest possible economic cost on the nation. That cost arises because all feasible taxes distort the incentives faced by firms and individuals, and impose related administration and compliance costs on the community; and

– equity - that is, the tax system should be capable of raising revenue in a manner that is consistent with widely accepted equity criteria.

Recognise that its ability to improve the efficiency and equity of the tax system is restricted by a number of factors including:

– information constraints, which limit the extent to which it is possible to improve the efficiency of the tax system by applying 'optimal' tax rates to different activities, and correct for market failure (eg via the imposition of so-called 'green' or excise taxes). This is the reason why successive governments have sought to improve the overall efficiency of the tax system using the much less informationally demanding approach of broadening the tax base, reducing tax rates and applying more uniform rates of tax;

- the inherent conflict between the objectives of the tax system, which means that complex trade-offs often have to be made, particularly between equity and efficiency objectives; and

- the fact that New Zealand is only a small capital importing nation, which limits its ability to impose tax on non-residents, or unilaterally influence the tax policies of other countries.

What is wrong with the current tax system?

- **The current tax system is, in some respects, inequitable:**

  – Individuals with the same annual income can face different tax burdens, due to the exclusion of certain forms of income from the tax base, differences in the measurement of different forms of income from capital, and differences in the tax treatment of different entities.

  - Individuals with the same lifetime taxable income can face different income tax burdens due to progressive tax rates and differences in the patterns of their consumption over their lifetimes.

  - Individuals who decide to work, save and invest less are compensated by other taxpayers who face higher effective marginal tax rates.

  - Much of the revenue raised from the taxation of higher-income individuals is redistributed back to those individuals in the form of subsidised goods and services. This 'churning' of tax revenue is neither equitable nor efficient, since a significant proportion of it is lost in the form of 'deadweight costs'.

- **The current tax system is, to some extent, inefficient.** In the course of raising revenue, the tax system imposes a 'deadweight' cost on New Zealand by unintentionally distorting decisions to work, save, invest, produce and use resources.

  – The current income tax regime:

    discourages saving and investment. Although New Zealand has reduced the effective marginal rates of tax on investment and the domestic cost of capital by reducing the rates of tax applying to the New Zealand sourced income of foreign investors, this means that the New Zealand tax system now imposes a much greater disincentive to save for any given personal tax rate;

    reduces the quality of investment by distorting:

      the New Zealand investment decisions of residents, since different effective marginal tax rates apply to different activities and investments due to the exclusion of certain forms of income from the tax base, differences in the way different forms of income from capital are measured, and differences in the tax treatment of different entities; and

the foreign investment decisions of residents, since the controlled foreign company, foreign investment fund, and underlying foreign tax credit regimes apply different effective marginal tax rates to investments in different jurisdictions; and

has an uncertain effect on the quality of the New Zealand investment decisions made by non-residents.

- The absence of GST on imported services and 'digital' goods supplied directly to final consumers also distorts patterns of consumption, production, investment and resource use. In particular, it places New Zealand suppliers of those services and goods at a competitive disadvantage in relation to foreign suppliers.
- The interaction of the income tax regime and benefit abatement regimes produces high effective marginal tax rates that discourage beneficiaries from re-entering the workforce and engaging in additional work when they take up employment.
- The level of taxes and the progressivity of the income tax regime reduce New Zealand's ability to attract and retain skilled workers.

How can we improve the equity of the tax system?

- **Review the combined impact of the tax and benefit systems.** Although a comprehensive review of the combined impact of the tax and benefit systems is beyond the terms of reference of the Review, we believe it is essential for the Review to:
  - highlight the need to limit assistance to those in most need in view of the high and increasing economic costs associated with raising revenue and redistributing income, and the harm associated with welfare dependency; and
  - identify the trade-offs that have to be made when designing equitable and efficient abatement regimes.

- **More progressive tax rates do little to improve equity and also reduce efficiency.** Increasing the progressivity of the tax system does very little to improve the equity with which income is distributed in New Zealand. A large proportion of the income raised from imposing higher marginal rates of tax on middle- and high-income households is given back to those households in the form of subsidised services. Such redistribution is unnecessary and ineffective. Increasing the progressivity of the tax system also reduces the overall efficiency of the tax system by:

  – increasing disincentives to work, save and invest;

  - reducing New Zealand's ability to attract and retain skilled labour;

  - increasing administration and compliance costs by reducing the government's ability to collect revenue efficiently through a single-rate withholding tax regime;

  - increasing the scope for income splitting;

  - increasing the incentive for high-income individuals to engage in tax planning; and

  - reducing the quality of investment by encouraging increased investment in concessionally taxed activities.

- **Extending the income tax base to include all income from capital, or introducing an annual wealth tax, is unlikely to improve the equity or efficiency of the tax system.** Rather than improve efficiency, the taxation of income from capital or assets on a realisation basis can reduce economic efficiency by locking taxpayers into the ownership of those assets and provides opportunities for taxpayers to reduce the amount of tax that would otherwise be payable by realising capital losses. For these reasons, we do not support either the introduction of a comprehensive capital gains tax or the introduction of more extensive assets taxation. A better approach is to reduce distortions in the tax treatment of investments by reducing high tax rates. However, we do recognise that it may be necessary to clarify the current boundary between taxable and non-taxable income from capital, including the current distinction between 'passive' and 'active' shareholdings, in order to reduce administration and compliance costs as well as potential erosion of the current income tax base.

- **Replacing GST with a financial transactions tax would not improve the equity or efficiency of the tax system.** The Alliance's suggestion to replace the GST with a financial transactions tax (FTT) would not improve either the equity or the efficiency of the tax system. Compared with GST, the proposed FTT would be a relatively inefficient source of revenue since it would: discourage saving and investment; distort patterns of investment; reduce the efficiency of financial markets; discourage exports and encourage imports of certain goods; be easier to avoid than a GST; and would lack the transparency of a GST.

- **Need to phase out remaining cheque and stamp duties.** Rather than introduce new transactions taxes, the government should phase out the remaining cheque and stamp duties as fiscal conditions permit.

How can we reduce the disincentive to save and invest?

- **Need to reduce tax rates.** With its broad income tax base, and relatively low rates of tax on the income of non-residents, the New Zealand income tax system imposes a much greater disincentive on saving for a given personal tax rate than the tax regimes applying in certain other jurisdictions. If we want to reduce tax disincentives to save, priority needs to be given to reducing the personal rates of tax that are imposed on both the labour and capital incomes of New Zealand residents. In particular, priority needs to be given to reducing high effective marginal rates of tax (including the top personal tax rate) since this strategy is likely to produce the greatest reductions in the deadweight costs of taxation.

- **A Nordic 'dual' income tax system would only encourage tax planning.** Several Nordic countries have sought to reduce tax disincentives to saving and investment by reducing the rates of tax on income from capital while continuing to subject income from labour to higher progressive rates of tax. However, this also encourages tax planning and distorts individuals' decisions regarding the manner in which they organise their business activities. In particular, it provides an incentive for individuals to incorporate and recharacterise their labour income as income from capital.

- **Special tax concessions would only erode the tax base and reduce the quality of investment.** Rather than increase overall levels of saving and investment, such concessions tend to reduce the overall quality of investment decisions. That is, they tend to divert investment from those activities that would be more beneficial to the nation as a whole. They also erode the tax base, thereby imposing higher tax rates on those activities that do not qualify for such concessions. In addition, tax concessions provide an open-ended level of assistance that is difficult to monitor and control. Often the benefits provided end up in the hands of individuals other than the intended recipients. The preferable approach to reducing tax disincentives to save and invest is to reduce the level of government spending and hence income tax, and raise a greater proportion of income via the GST regime.

- **Increased 'green' and excise taxation is not the answer.** In practice, such 'optimal' taxes are extremely difficult to design since they require detailed information on the marginal damage arising from the 'undesirable' activity in question. As a result, there is a real risk that such taxes will reduce rather than improve economic efficiency. Instead of introducing new 'green' or excise taxes, we believe the government should review the extent to which existing excise taxes are achieving their objectives. In particular, priority should be given to a review of the current excise taxes imposed on alcohol and fuels. Unless a compelling case can be made for the retention of existing alcohol excises (which we doubt), they should be removed. Similarly, the use of the petrol excise as a means of charging for road use needs to be reviewed in the light of recent changes in technology that make direct charges for road use more feasible. The general revenue element of the excise tax on petrol should be abolished.

- **Introducing a carbon charge would only impose a net cost on New Zealand.** The government is still pursuing the development of a carbon charge, or tradeable emission permits, to reduce greenhouse gas emissions even though the case for such intervention has not been established:

  – The impact of greenhouse gas emissions on both global and regional climate change is highly uncertain.

  - There is no evidence to suggest that the forecast climate changes would be more likely to impose a net cost rather than confer a net benefit on New Zealand.

  - There is no evidence to suggest that the implementation of a carbon charge would be of net benefit to New Zealand. Indeed, the introduction of carbon charges, tradeable emission permits and mandatory energy performance standards could impose significant costs on the community with no compensating improvement in New Zealand's climate.

  - There is no case for New Zealand, a middle-income country, imposing costs on its economy in the absence of concerted action by countries which have higher levels of income and are larger emitters.

  We support the government's decision to forward any proposal to introduce a carbon charge to the Review, as well as the proposal to hold an inquiry into the impacts of climate change and the actions New Zealand should be taking to adapt to and manage those risks.

How can we improve New Zealand's ability to attract and retain highly skilled labour?

- **Reduce tax rates.** The preferable approach to improving New Zealand's ability to attract and retain highly skilled labour is to reduce tax rates so that a lower and more uniform rate of tax applies to all forms of income, including labour income. This is best achieved via a reduction in the top marginal tax rate, since this could be expected to produce the greatest gains in economic efficiency. Intermediate rates should also be reduced as fiscal circumstances permit. There is also a case for putting a cap on the total amount of income tax that would have to be paid by an individual.

How can we improve the quality of investment?

- **Review the current tax treatment of foreign investment by residents.** The current tax system distorts the foreign investment decisions of residents by imposing relatively high and disparate effective rates of New Zealand tax on the income that they derive from their investments in other jurisdictions. In particular, the effective tax rates applying to investments in non grey-list countries are now much higher than was originally envisaged, and the effective tax rates applying to investments in grey-list countries and certain domestic investments are now much lower. There is a need to review the tax treatment of foreign investment by residents in the light of these developments.

- **Consider the scope for further reductions in the rates of tax applying to foreign equity investment.** New Zealand has already made considerable progress in lowering the domestic cost of capital by reducing the rates of tax imposed on investment financed by non-resident debt (through the introduction of the approved issuer levy (AIL) regime) and, to a lesser extent, non-resident equity (through the introduction of the foreign investment tax credit (FITC) regime). We believe that consideration needs to be given to reducing the maximum rate of tax applying to non-resident equity investment to a level below the current company tax rate of 33 percent.

- **Consider the scope for further improvements in the measurement of New Zealand sourced income.** At the moment, it is assumed that all of the dividend income distributed by a company is sourced from the country in which that company is resident. Although this arbitrary rule may have worked reasonably well in the past, the residence of a company for tax purposes is now no longer a reliable guide to the actual economic source of the dividend income it distributes. This can result in inaccuracies in the measurement of the amount of New Zealand sourced income derived by a taxpayer. We believe it would be useful for the Review to:

  – document the problems arising from the current approach to defining the source of dividend income;

  - outline the reasons why it is difficult for New Zealand to unilaterally resolve this tax base problem without deviating from the OECD model which underlies New Zealand's double tax treaties (ie it is difficult for New Zealand to unilaterally redefine the source of dividend income);

- discuss the manner in which New Zealand has sought to address these problems to date by altering the rates of tax applying to dividend income (eg through the introduction of 'conduit' relief);
- identify the problems that remain with the determination and accurate measurement of New Zealand and foreign sourced dividend income; and
- identify broad options for addressing those problems.

- **Consider the imposition of GST on certain imported goods and services.** The absence of GST on certain imported services reduces the efficiency with which the economy operates by distorting patterns of consumption, production and resource use in New Zealand. The Review should consider whether it would be efficient to extend the GST regime to certain types of imported services by:
  - requiring non-resident telecommunications companies that wish to supply services to New Zealand residents to levy GST on those services (eg by requiring those entities to be registered for GST purposes); and
  - applying a reverse charge to entities registered for GST that import services that are subject to GST but are not eligible for input tax credits (ie require those entities to levy GST on their imports of exempt supplies of services such as financial services).

Keep it simple

The tax system involves large compliance costs for individual taxpayers and firms, as well as costs of administration. Businesses consistently report that the tax system generates the major compliance cost that they have to face. The government is currently seeking to reduce business compliance costs. In the tax area and others, serious reductions will only be achieved by changing underlying policies. No amount of effort to rewrite the Income Tax Act, for example, will make much difference if unnecessary complexity in the tax system is retained. The TOLIS (Taxation of Life Insurance and Superannuation) exercise demonstrated that there is no satisfactory way of designing efficient arrangements and reducing compliance costs when the tax scale is made more complex. The government's action in further widening the tax scale has greatly increased compliance costs. For example, New Zealand's fringe benefit tax, which was initially designed to minimise compliance costs, has now become much more complex. New Zealand needs tax law which is as simple as possible to minimise the costs of working and doing business here and create competitive advantages vis-à-vis other jurisdictions. The Review group should place considerable weight on this objective.

1 INTRODUCTION

The New Zealand Business Roundtable (NZBR) welcomes the opportunity to make this submission to the Tax Review (the Review).

The New Zealand Business Roundtable is an organisation comprising primarily chief executives of major New Zealand businesses. The purpose of the organisation is to contribute to the development of sound public policies that reflect overall New Zealand interests.

The primary purpose of the tax system is to finance government expenditure. The level of government spending generally provides the best overall measure of the tax burden. The Review should therefore focus, in the first instance, on the level of government expenditure that might properly be funded from taxation over the medium to longer term.

The level of government spending has risen sharply over the past century. At the beginning of last century, governments in many advanced countries typically spent around 10 percent of national income and taxed their citizens accordingly. This was the era of small or limited government, not just in the spending activities of governments but also in their roles as regulators of economic activity and as owners of businesses and providers of services. New Zealand conformed to this pattern, and about 100 years ago average income levels in New Zealand were among the highest in the world.

By contrast the twentieth century was increasingly one of big government. Government spending accounts for around 50 percent of gross domestic product (GDP) in Western Europe, a third or more in English-speaking economies and about 20 percent in the Asian region. Both Singapore and Hong Kong have recorded rapid growth over recent decades while keeping government spending to around 15 percent of GDP. The OECD puts New Zealand's ratio of general government spending, which includes spending by local government, at 40 percent of GDP. We have also seen the vast expansion of the modern regulatory state and of central and local government ownership of many commercial activities. Only in the past two decades or so have these trends been partially reversed.

There is considerable research which finds that high taxes impose very large costs on the community. These costs include lower output, incomes and employment than otherwise, and distortions to many other choices that people make every day. They are known as the deadweight costs of taxation. Such costs increase more than proportionately as the rate of tax increases. Moreover, deadweight costs can be expected to be increasing with open borders, mobile capital and, increasingly, internationally mobile labour.

It is implausible that marginal expenditure projects in New Zealand yield the return required to justify the deadweight costs of taxation. Much of the growth in government spending arose from the provision of private goods and services, such as most health and education expenditure, and welfare payments. The welfare system, though motivated by good intentions, has weakened the work ethic, undermined the acceptance of personal responsibility and led to state dependency for many people. Significant social expenditure, such as the payment of New Zealand Superannuation to people who are well off by any standards, and subsidisation of tertiary education for people who come from families that earn above average incomes, has perverse equity effects.

A significant reduction in the level of government spending relative to GDP over the medium term is desirable on economic and social grounds. The level of expenditure that needs to be funded from taxation in the future is best determined by focusing on the core or essential roles of the government.

The government has a vital role in the economy. There are some functions such as the provision of defence, courts, police, democratic institutions and relationships with other sovereign states that only the government can undertake. The essential activities of the government all relate to the provision and/or funding of public goods. These are goods and services that cannot be supplied adequately, if at all, through market transactions in the private sector. Unless the government arranges for the provision of public goods, efficiency will be impaired and overall community welfare will be reduced.

The government's role is, however, limited. The protection of freedom and promotion of efficiency require that most activities be left to civil society, which comprises individuals, private firms and voluntary associations. The provision of private goods that can be exchanged in the market or organised through voluntary organisations should be undertaken in the private sector.

The government must also pursue social objectives. While society may wish to ensure that everyone has adequate access to services such as education and health, this does not require the government to own tertiary institutions and hospitals, or to provide such services. Moreover, it is not necessary for the government to fund those services for the majority of people who could afford to pay for themselves in a lower tax environment. Such 'middle class welfare' merely involves the collecting of large amounts of revenue from taxpayers which is then spent for the benefit of the same taxpayers through costly bureaucracies which face little pressure to perform. The economic or deadweight losses associated with such 'churning' are very large.

Social spending could also be reduced substantially by removing obstacles to employment that have been created in recent years, such as inappropriate employment laws, and by welfare reforms similar to those adopted in the United States. There should also be greater reliance on private insurance arrangements to cover contingencies such as disability, illness and premature death, and private savings for income in retirement.

We believe that a principled analysis of the role of the government, against the background of policies aimed at increasing the rate of economic growth and firm fiscal discipline, would conclude that a substantially lower level of government spending is required in the future. The report *Moving Into the Fast Lane* produced by the NZBR and the Auckland and Wellington chambers of commerce outlined a programme for reducing spending to below 20 percent of GDP by 2005. There have been steady reductions in the public expenditure ratios of most OECD countries since 1993 (since 1996, New Zealand has been one of the few exceptions to this trend). In Ireland, where the ratio was over 50 percent in the 1980s, it is projected by the OECD to fall to 26 percent in 2002.

This judgment is consistent with that of a leading researcher on economic growth, James Gwartney of Florida State University, who has argued that for most countries, government spending and taxation levels in the range of 10 to 15 percent of GDP are perfectly adequate for the core government functions of providing a range of public goods and a social safety net (including underwriting access to needed social services). Even spending levels of 20 to 25 percent of GDP may not be too damaging if the spending focuses on core functions and is designed to minimise the adverse impact on incentives to earn, save and invest. Gwartney goes on to say:

> As government spending moves to 30, 40 and 50 percent of GDP, however, it will undermine both the incentive to earn and the market process. The

> effects on growth may not be immediately obvious because it takes time for markets to adjust and people to alter their habits and social norms. Modern growth is primarily about gains from trade, discovery and innovation. The adverse effects of government on these activities may not be immediately observable … but with time, there will be observable effects on long-term growth (personal communication).

In response to the question of why growth in New Zealand has not been more robust, Gwartney writes that:

> … while there has been some reduction in the relative size of government (and improvement in performance), New Zealand is still a big government welfare state. Government spending [central plus local] continues at nearly 40 percent of GDP, a figure much too large for maximum growth (*ibid*).

In the NZBR's view, the government should establish a goal under the Fiscal Responsibility Act 1994 of reducing central government spending to 30 percent of GDP or below over the next few years as a step towards a lower target. Some of this reduction could be achieved by holding the rate of growth of government spending below the growth rate of the economy. A reduction in government spending would enable tax rates to be lowered and help to boost economic growth. It would also mean that there is no requirement to change the structure of the tax system by, for example, introducing new tax bases. Instead, the main focus of the Review should be to take stock of the substantial progress that has been made in improving the efficiency of the tax system and identify areas where further improvements can be made, consistent with the broad principles that have guided tax reform since 1984.

1.1 TERMS OF REFERENCE

The terms of reference indicate this fundamental review of the tax system will be conducted in two stages.

The Review is the first stage of that process. As outlined below, the terms of reference, which are set out in Attachment A, in combination with other related media statements, indicate that the main function of the Review is to establish an appropriate framework within which to build tax policy. In particular, the Review is intended to:

- identify the broad principles that should govern the development of tax policy and the structural design of the tax system; and
- provide a clear idea of the types of policies that would arise from the application of those broad principles.

Once the government has considered the recommendations of the Review, it intends to announce its views on the principles that should guide tax policy and the appropriate structure of the tax system.

The second stage of the process will involve the development of detailed proposals for reform that can be put before the New Zealand public in the 2002 general election.

1.1.1 Identification of broad principles

The first main function of the Review is to identify the broad principles that should be applied by the government when developing tax policy. As noted by the minister of revenue in his 31 July 2000 media statement, *Terms of Tax Inquiry*, the Review "... will involve designing a set of principles to guide tax policy and the general structure of the tax system".

Those principles need to cover the key tax policy issues that arise throughout the course of the generic tax policy process (GTPP) that has been endorsed by successive governments since its introduction in 1995.

In particular, the Review needs to develop principles that will help the government to:

- determine the role that the tax system should play in achieving the government's economic and social policy objectives; and
- assess how well the current tax system is performing that role and identify and evaluate broad options for reform.

The role of the tax system is determined during the 'strategic phases' of the GTPP which involve the development of the government's:

- Economic Strategy. This first phase of the GTPP requires an evaluation of the merits of tax policy initiatives, in relation to alternative policy instruments, as means of achieving the government's economic and social policy objectives.

- Fiscal Strategy. This second phase of the GTPP requires the determination of the amount of revenue that needs to be raised by the tax system, as opposed to other potential means of raising revenue such as issuing government stock and applying government charges.

These strategic phases culminate in the development of the Revenue Strategy (phase 3 of the GTPP) which outlines the role to be played by the tax system in achieving the government's fiscal objectives as well as its broader economic and social policy objectives.

It is clear from the terms of reference that the government wants the Review to concentrate on the ability of the tax system to perform its principal role of raising sufficient revenue to finance government expenditure. In the budget speech the government announced that:

> *We will set up a broad-based and wide ranging tax review to advise on the principles and structures best suited to sustaining a robust revenue base over the long term.*
>
> The review will concentrate on how it is possible to ensure a sustainable and continuous flow of revenue to meet Government requirements in the face of changing economic, social and technological conditions. It will form the basis of advice to the Government in broad terms about whether the New Zealand tax system can be improved.

Task (b)(iii) of the terms of reference requires the Review to address the following question:

> How can the level of tax that is reasonably required by the government for the provision of essential services such as health, education, superannuation and social welfare be achieved reliably in the medium and long term bearing in mind the need for the tax system to be an effective instrument of fiscal policy in the management of the economy?

In order to answer this question, the Review will have to reach a view on the appropriate role of the government and the amount of revenue that the government will reasonably need to raise over the medium to longer term to fund essential services. It will, for instance, need to determine, at least in broad terms, the essential services that the government should fund by way of taxation in the twenty-first century. This matter is examined further in section 2.

While raising revenue to fund essential services is by far the most important role of the tax system, it is not its only role. The tax system is also currently used to encourage or discourage certain activities and to redistribute income between individuals to further the government's economic and social policy objectives. This is recognised to some extent in the terms of reference which highlight the need to ensure the tax system is consistent with the government's wider policy objectives:

> Ideally the tax system should raise revenue simply, efficiently, fairly and reliably in an environment of changing technology, growing globalisation and increasing complexity. It should do this in ways that do not materially undermine the environment, social cohesion or the effective use of resources.

In particular, task (a) of the terms of reference requires the Review to:

> Assess the extent to which the tax system can contribute to broader social and economic objectives such as encouraging secure, high-quality employment, generating a fair distribution of income, maintaining a sustainable environment and promoting higher savings.

More specifically, task (b) of the terms of reference raises two main questions relating to the role that the tax system should play in achieving the government's economic and social policy objectives:

- Can the tax system be made fairer in its role of redistributing income?
- How can the tax system be designed to encourage desirable behaviour (eg work and savings) and discourage undesirable behaviour (eg the wasteful use of non-renewable resources)?

In order to address tasks (a) and (b) of its terms of reference, the Review therefore needs to establish the principles that should be applied by the government when determining the role the tax system will play in achieving its broader policy objectives.

The Review also has to establish the principles that the government should apply when:

- assessing the extent to which the current tax system is performing its role; and
- evaluating options for tax reform.

These tasks need to be performed during a number of phases of the GTPP including:

- the 'tactical' phases, which involve the identification and evaluation of broad proposals for tax reform and the preparation of the government's three year tax reform work programme;

- the 'operational' phases, which involve the development of detailed proposals for tax reform; and
- the 'implementation and review' phases, which involve post-implementation reviews of the effectiveness of regimes, and the identification of 'remedial' amendments to improve the operation of regimes.

1.1.2 Application of principles

The second main function of the Review, which is expected to occupy most of the Review's time and effort, is to apply those broad principles to:

- evaluate how well the tax system is performing its role; and
- identify broad options for tax reform.

As noted in the terms of reference, the functions of the Review are as follows:

> i to examine and inquire into the structure and effects of the present tax system in New Zealand;
>
> ii to formulate proposals for improving that system, either by way of making changes to the present system, abolishing any existing form of tax, or introducing new forms of tax; and
>
> iii to report to Parliament through the Minister of Finance, the Minister of Revenue and the Minister of Economic Development.

Specifically, the terms of reference require the Review to:

> (b) Recommend structural changes for the tax system, if appropriate. In doing so the Review will focus on the following questions:
>
> i Can the tax system be made fairer in its role of redistributing income? This includes considering whether the income tax base should be broadened and the extent to which marginal rates should increase with levels of income, wealth and expenditure. The Review should consider the best mix between different tax bases such as income, consumption, financial transactions and wealth.
>
> ii How can the tax system be designed to encourage desirable behaviour (eg work and savings) and discourage undesirable behaviour (eg the wasteful use of non-renewable resources)?

iii How can the level of tax that is reasonably required by government for the provision of essential social services such as health, education, superannuation and social welfare be achieved reliably in the medium and long term bearing in mind the need for the tax system to be an effective instrument of fiscal policy in the management of the economy?

iv Do the tax system and tax rates need to be modified in light of new technology and international competition?

That is, the Review is being asked to provide advice on the manner in which the efficiency and equity of the current tax system can be improved. It is not being asked to completely redesign the tax system.

This will require the Review to evaluate a range of potential reforms including a number of topical options such as the extension of the income tax base to include a wider range of income from capital, the introduction of a financial transactions tax, so-called 'green' taxes, and assets taxes.

It is incumbent on the Review to establish that any proposals that it makes will improve overall national welfare.

1.2 STRUCTURE OF THIS SUBMISSION

The remainder of the submission addresses the main functions and tasks outlined in the terms of reference of the Tax Review.

Section 2 identifies the broad principles that should be applied by the government when developing tax policy. The first part of section 2 identifies the broad principles that should be applied by government when determining the role that the tax system should play in achieving its economic and social policy objectives. The second part of section 2 identifies the principles that should be used by the government when assessing how well the current tax system is performing its role and evaluating alternative options for reform.

Sections 3 and 4 then apply those principles to the key tax policy issues raised in tasks (a) and (b) of the terms of reference:

- Section 3 applies those principles to assess the extent to which the current tax system is achieving its desired role; and
- Section 4 applies those principles to evaluate various options for reform.

2 PRINCIPLES TO GUIDE TAX POLICY DEVELOPMENT

An important function of the Review is to establish a framework for tax policy development. This will require the Review to identify the broad principles that should be applied when the government is:

- determining the role of the tax system; and
- reviewing and reforming the current tax system to improve its ability to perform that role.

2.1 DETERMINING THE ROLE OF THE TAX SYSTEM

What principles should the government apply when it is determining the role of the tax system?

This is one of the most important, yet frequently overlooked, questions in the process of tax policy development. It involves assessing the role that the tax system is expected to play in achieving the following objectives of the government:

- fiscal objectives (eg issues such as the amount of revenue that should be raised using the tax system as opposed to other potential policy instruments such as government charges and debt);
- social policy objectives (eg issues such as the extent to which the tax system, as opposed to other policy instruments such as direct government grants, should be used as a means of redistributing income between individuals); and
- broader economic and social policy objectives (eg issues such as the extent to which the tax system, as opposed to other policy instruments, should be used to promote economic growth, promote 'desirable' activities such as savings and investment, and deter 'undesirable' activities such as pollution).

It is important to note that the tax system is only one of a wide range of instruments that the government has at its disposal to achieve its objective of improving national welfare. This means that when determining the appropriate role of the tax system, the government should apply the same broad set of principles that it uses when it is determining its role and the role of each of its policy instruments. That is, it should be seeking to identify the nature and extent of 'market failure' and 'government failure', and to determine the extent to which government intervention is capable of reducing market failure and improving national welfare.

Unfortunately, as outlined below, up until the mid-1980s governments in New Zealand and many other OECD countries made numerous decisions to intervene in the economy with apparently little thought for either the effectiveness of their interventions or the potential risk and costs of government failure.

Over the last two decades, broad principles and processes have been developed to assist the government with the review and reform of its role, and the role of the tax system, in order to reduce the risk of further government failure. Those principles, which are outlined in section 2.1.2, are well established. They are set out in the government's generic tax policy process and are also a feature of its 'sustainable development' strategy and the Regulatory Impact Statements that must accompany proposals for regulatory reform to Cabinet.

2.1.1 The changing role of government

Addressing market failure

It is generally accepted that the government has an important role to play in the economy. This includes:

- correcting for the failure of the market to provide certain 'core' services including genuine public goods such as defence, law and order and some environmental amenities; and
- the provision of a social safety net, including access to services such as health and education by those on lower incomes.

However, it is also recognised that in seeking to correct for perceived market failures, many governments have extended their roles well beyond the provision of those 'core' services. As noted by the OECD (1999a):

> Without exception, in the countries in the study, government roles and functions expanded dramatically during the 1960s and 1970s as a means to improve infrastructure, to strengthen the welfare state or to provide employment. As a result, the reach of government came to extend into almost every sphere of activity in the lives of citizens, and the business and community sectors. Governments set policy, determined regulation, subsidised certain activities, and owned, funded and delivered services as diverse as finance and insurance as well as welfare services including almost all education and health services. Energy, environment, agriculture, housing and many other services were also covered, including those associated with developing the basic infrastructure (such as railways and road). The service provision by the state extended well beyond what might have been considered as the traditional 'core' activities such as law and order, personal and public safety, and national security - into many commercial activities.

In the rush to address perceived market failures, governments often paid insufficient attention to identifying the precise nature and extent of that market failure, evaluating the merits of alternative forms of intervention, and determining whether or not government intervention would improve matters. In particular, as noted by the OECD (1999a), insufficient attention was given to the risk that such government intervention might fail, and the costs that would arise from government failure:

> In determining whether or not government should intervene through regulation, service provision or other means, market failure considerations usually dominated decisions with little or no consideration given to the possibility and cost of government failure. Yet instances of government failure clearly had occurred in areas such as education, equity, health and redistribution of wealth.

Reducing government failure

By the mid 1980s, many governments were recognising that they had extended their roles far beyond the provision of the traditional 'core' services and their tax systems were unable to raise sufficient revenue in an efficient manner to finance projected increases in expenditure and service the costs of mounting debt.

Rather than improve the operation of the economy, increasing intervention had created economies heavily reliant on the government to provide an increasing range of goods and services to the community and assistance to domestic industry. In the face of increasing imports, taxes and government regulation, domestic industries found it difficult to compete and became more reliant on governments to provide assistance in the form of restrictions on imports and tax concessions. Those trade restrictions further reduced the efficiency of domestic industry and the provision of open-ended tax concessions reduced the size of the tax base, forcing governments to increase tax rates to collect more revenue.

In addition, there was growing recognition of the high costs of raising tax revenue. High and disparate rates of income tax were stifling domestic saving and investment, reducing the overall quality of investment, and resulting in high compliance and administrative costs. Attempts were made to provide certain 'favoured' activities with some relief from these high rates through tax concessions. However, these concessions only served to narrow the tax base even further, creating additional distortions in patterns of investment, and increasing administration and compliance costs by increasing the complexity of the tax system.

In response to slow growth, mounting fiscal pressures and the high cost of raising tax revenue, many governments were forced to reconsider their roles in the economy and to implement a wide range of reforms aimed at reducing the extent of government failure by:

- opening up their domestic economies to increased international competition (eg through trade liberalisation, financial market deregulation, removal of exchange controls and the relaxation of controls on foreign investment);
- improving the ability of their domestic economies to adjust to, and take advantage of, changes in their economic environment (eg through regulatory and infrastructure reforms);
- improving the equity and efficiency of their tax systems (eg by broadening the tax base and reducing rates of tax); and
- improving the overall efficiency of government (eg through state sector reforms).

This process of reform is by no means complete. Increasing international competition arising from the rapid expansion in international trade and foreign investment, fuelled by advances in transport, telecommunications and computer technology, will continue to force governments to reconsider both their core roles and the roles of their tax systems.

There is still considerable scope for the government to reduce tax rates by reducing government involvement in activities that could be performed more efficiently by the private sector. For example, it is hard to justify the government's continued involvement in activities such as running Lotto, television stations, coal mines, ports, airports, electricity businesses, property companies, forestry operations, and the accident insurance scheme. It is also hard to justify the provision of social welfare services that are well in excess of those required to provide a sufficient social safety net for people who cannot support themselves and cannot be supported in other ways, for instance by family, friends and charities. Private insurance arrangements, for example, could provide income for most people in the event of contingencies such as illness and disability, non-custodial parents should be held responsible for their children, and private saving arrangements should provide income in retirement for future retirees.

A comprehensive expenditure review is outside the terms of reference of the Review. However, the Review is required to examine how the level of tax that is reasonably required by the government for the provision of essential services can be raised reliably in the medium and long term. This requires identifying essential services and assessing the level of expenditure that is required to fund such services, and thus the necessary level of tax revenue.

2.1.2 Principles to guide the determination of the role of the tax system

Although there is still considerable debate in New Zealand about the appropriate role and size of the government, there is broad consensus about the principles the government should apply when determining the role of the tax system.

The fundamental principle that should guide the development of all government policy initiatives, including new tax policies, is the need to ensure that the proposed initiative will improve national welfare to the greatest extent possible.

Need to determine the nature and extent of the problem and establish the case for government intervention

Before deciding to intervene in the economy, using either the tax system or some other policy instrument, it is essential to:

- determine the nature and extent of the market failure such intervention is intended to correct; and
- establish that government intervention is necessary to correct that market failure.

For example, when determining whether to introduce a carbon charge to reduce greenhouse gas emissions, it is essential to:

- determine the nature and extent of the net costs (if any) that unabated greenhouse gas emissions are expected to impose on New Zealand; and
- establish that the introduction of a carbon charge has the capacity to reduce those emissions and improve national welfare.

Similarly, before intervening in the economy to raise tax revenue to fund, say, the provision of certain goods and services, it is essential to:

- determine the nature and extent of the market failure that is causing the under-supply of those goods and services; and
- establish that such intervention is warranted and is expected to result in an overall improvement in economic efficiency.

Even if it is possible to establish that the market is failing, this still does not mean that the government should intervene. As outlined below, it is also necessary to establish that the government has the ability to intervene and actually improve the efficiency or equity with which the market operates. The same factors that have caused the market to fail can also inhibit the ability of the government to intervene and lead to government failure.

Need for clearly defined and realistic objectives

Having established a potential case for government intervention, it is necessary to clearly identify the objective of the proposed government intervention. In particular it is important not to simply state that the objective is to cure the problem. Rather, it is important to set realistic targets so that the effectiveness of the intervention can be monitored and reviewed.

Need to identify and evaluate alternative policy instruments

Once the objectives of the proposed intervention have been established, it is important to identify and evaluate alternative policy instruments the government could use to achieve them.

For example, when considering whether to use the tax system to encourage or discourage some type of activity, it is important to ensure that the tax system is a more effective instrument than feasible alternatives such as government regulation or government subsidies.

Similarly, when considering how to finance government expenditure it is important to consider sources of finance other than tax.

In the past, many governments assumed that almost all current revenue required to finance its expenditure should be raised by the tax system. User charges were rarely applied. It is important to recognise, however, that the tax system is not the only instrument that the government can use to finance projects, and it is certainly not the most appropriate form of finance in all cases.

For example, it may be prudent for a proportion of government expenditure on certain projects to be financed by debt in order to allocate the cost to individuals who will benefit from the projects over their economic life. However, debt finance should not be used to fund projects that are not expected to be self-financing (eg student loans that are not expected to be repaid).

Direct user charges are usually the most appropriate form of finance when the government expenditure produces private benefits (eg expenditure on post-compulsory education, health, water supply and refuse disposal). Such charges:

- ensure that the cost of those services is met by those who benefit;
- deter over-use of those services; and
- provide the government with valuable information concerning which services to expand, since consumers will weigh up the cost of those services against the value they place on them.

Direct user charges differ from taxes in a number of respects. Direct charges are voluntary and relate to the provision of particular goods or services. That is, individuals do not have to pay a charge unless they want to consume the service provided by the government. By contrast, taxes tend to be compulsory and are not directly related to the supply of particular government goods or services. For example, income tax is compulsory, regardless of whether the taxpayer consumes the goods and services it funds. In addition, voluntary services for which direct user charges are applied are subject to competition. That is, the consumer can choose to obtain the good or service from another source if the direct charge is considered to be too high. By contrast, taxpayers do not have the option of paying less income tax if they choose not to consume the services that it funds. Compulsory charges for services that are not subject to competition exhibit many of the features of a tax.

When designing user charges, however, care needs to be exercised so that they do not become yet another distorting tax. The design of appropriate user charges is just as difficult as the design of 'optimal' taxes. Poorly designed user charges can reduce, rather than improve, economic efficiency in just the same manner as a poorly designed 'optimal' tax.

Where voluntary direct user charges are appropriate, the question arises as to why the government is providing such services. By definition the services in question are in the nature of private rather than public goods and should normally be provided by the private sector. If the government wishes to ensure access to such services, it should generally make targeted subsidies available to the intended beneficiaries.

Indirect charges may be more appropriate than direct user charges in those cases where the transactions costs associated with levying direct user charges are prohibitive. For example, there was a case in the past for the imposition of an indirect charge such as the petrol excise in view of the high transactions costs associated with calculating and levying direct charges on cars using non-toll roads. Recent advances in technology, however, have produced more efficient techniques for charging road users for their actual road use (eg hubometers to measure distance travelled; tachographs to measure speed, distance, and time; and electronic vehicle tagging and global positioning systems, which are also capable of determining actual roads used).

By contrast, the tax system tends to be a more appropriate source of finance in those cases where neither regulation nor government charges are feasible and the government expenditure produces widespread public, rather than private, benefits (eg in the case of expenditure on law and order, defence, etc). It is important to note, however, that the existence of a public benefit is not sufficient justification to use tax revenue to finance a project. As noted below, it is also necessary to ensure that the benefits of that expenditure are at least sufficient to provide a normal rate of return and cover the additional deadweight costs associated with raising that tax revenue.

If the government followed these basic principles when financing its existing expenditure it would be possible to reduce the overall level of taxation.

Need to establish that intervention will produce net benefits

Finally, it is important to establish that the proposed intervention will produce a net benefit for New Zealand. This requires consideration of all of the social benefits and costs of the proposed intervention, including the deadweight costs associated with raising any tax revenue required to finance the project.

In particular, for projects to be financed by tax revenue, it is necessary to establish that the potential benefits of intervention are sufficient to generate not only a normal rate of return, but also an additional rate of return to cover the deadweight costs of raising that tax revenue.

2.2 REVIEWING AND REFORMING THE CURRENT TAX SYSTEM

What principles should the government use when it is reviewing and reforming the current tax system?

As outlined below, ideally the tax system should be capable of performing its role in a manner that is efficient, equitable and consistent with the government's broader economic and social policy objectives. In reality, however, there are a number of factors that constrain the government's ability to design a tax system that is capable of simultaneously achieving all of those objectives. These practical constraints have important implications for the design of the tax system.

2.2.1 Efficiency

Ideally, the tax system should be 'efficient'. That is, it should be capable of performing its role in a manner that minimises its impact on the incentives that individuals and firms face.

Deadweight costs of raising tax revenue

In reality, all feasible tax systems are inefficient to some extent. In the course of raising and redistributing revenue and correcting for market failure, the tax system unintentionally reduces the efficiency with which the economy operates by distorting decisions to work, consume, save, invest, produce and use resources.

For example, in the course of raising revenue, an income tax unintentionally reduces the level of saving and investment. It also unintentionally reduces the overall quality of investment, since it is rarely possible to include all forms of income in the tax base, or to measure that income as it accrues to the taxpayer. As a result, income from different investments is usually subject to different effective marginal tax rates, thereby distorting patterns of investment.

These unintended effects reduce overall efficiency, thereby imposing a cost on the nation as a whole. As a result, the total revenue raised by the tax system is less than the total cost of raising that revenue by an amount referred to as the 'excess burden' or 'deadweight cost' of taxation. This is the reason why the tax and benefit systems are often likened to a 'leaky bucket'. In the course of raising and redistributing revenue, some of that revenue is lost due to the deadweight costs of taxation.

In general, the deadweight costs of raising an additional dollar of tax revenue are greater:

- the higher the levels of effective marginal tax rates - the deadweight costs of taxation increase more than proportionally with increases in the tax rate;

- the greater the disparities in those effective marginal tax rates across alternative activities; and
- the more responsive decisions to work, save, consume, produce and invest are to high and disparate effective marginal tax rates.

Administration and compliance costs

Administration and compliance costs are important components of the deadweight costs of taxation. In order to comply with their obligations under the tax system, individuals and firms must divert some of their resources to calculating their tax liabilities and collecting tax on behalf of the government. In addition, the government has to divert resources from the private sector in order to administer the tax system. This tends to reduce the overall efficiency with which resources are used in the economy, thereby increasing the deadweight costs of raising and spending tax revenue.

Simplicity and certainty

Simplicity and certainty are also important requirements for an efficient tax system. Administration and compliance costs arising from the tax system tend to increase as the tax system becomes more complex and less certain.

Taxpayers need to understand their obligations under the tax system in order to comply with it and self-assess their tax. Similarly, the Inland Revenue Department needs to be able to determine the obligations of taxpayers in order to administer the tax system. Taxpayers also need to know how their activities will be taxed in the future in order to plan their savings, investment, consumption, production and resource use. Uncertainty concerning the current or future tax treatment of activities can have detrimental effects on investment decisions and the potential for increased economic growth.

2.2.2 Equity

Ideally, the tax system should also be 'equitable'. That is, it should be capable of performing its roles of raising income in a manner that is consistent with the government's equity objectives.

The concept of equity is subjective and governments rarely provide a clear statement of their equity objectives. This makes it extremely difficult to assess the extent to which the tax and benefit systems are achieving them. For example, as outlined in Buchanan and Hartley (2000), the term 'equity' is used to refer to a range of different concepts including:

- fair or equal treatment;
- equality of opportunity;
- equality before the law;
- equality of income;
- horizontal and vertical equity;
- inter-generational equity; and
- unequal treatment to reduce inequalities arising from other sources.

In addition, it is important to note that the tax system is only one of several policy instruments that the government often uses in combination to achieve its equity objectives. Other important policy instruments include the social welfare system, the provision of subsidised services, direct government grants and government charges. This means that it is not possible to determine the extent to which the government's equity objectives are being achieved simply by looking at the effects of the tax system on the distribution of income. Rather, it is necessary to consider the combined impact on the distribution of income of all policy instruments. This is an extremely difficult, if not impossible, task given the level of government regulation, taxes and spending.

Equalising incomes or reducing poverty?

Of particular concern to the NZBR is the notion that equity requires the equalisation of incomes.

This notion is embodied in the Gini coefficient used by statisticians to evaluate changes in the distribution of income. This coefficient measures the extent to which the actual distribution of income differs from an equal distribution of income across all individuals. Many analysts and commentators associate an increase in the equality of income with an 'improvement' in equity.

However, the Gini coefficient is a deficient measure of equity. For example, if individuals on high incomes experienced a drop in income and the incomes of all other individuals remained unchanged, the Gini coefficient would suggest there had been an 'improvement' in the distribution of income. It is hard to see how equity is improved in this situation.

Equalising the incomes of individuals regardless of their age, ability, preferences and work effort is neither equitable nor efficient. There is little social benefit to be obtained from seeking to redistribute income between individuals who are already relatively well off. Such redistribution is motivated more by envy for people on higher incomes than concern for the welfare of those individuals who are unable to care for themselves. By contrast, there are considerable social costs associated with such redistribution. In the course of redistributing that income, both the tax and benefit systems impose significant deadweight costs on the nation as a whole. The increasing marginal tax rates generated by such a policy act as an increasing disincentive for individuals to work, save, invest, produce and innovate. They send a perverse signal to the community about the value placed on hard work and innovation.

Rather than focus on equalising incomes, a preferable goal is to focus on the reduction of poverty. The potential gains in 'equity' to be obtained from redistributing income between individuals who already have a good standard of living are simply too low to warrant the high efficiency costs associated with that redistribution.

Ability to pay

Some indication of the equity of the tax system may be obtained using a concept of equity that is based on the ability of the taxpayer to pay tax. Using this concept of equity, a tax system is considered to be equitable when it imposes:

- the same tax burden on individuals who have the same ability to pay (horizontal equity); and

- a higher tax burden on individuals who have a greater ability to pay (vertical equity).

However, ability to pay is a deficient concept of equity. Consider, for example, two people, A and B, who are equal in all respects except that A values leisure more highly than B and therefore works on a half-time basis. B works full time. B would generally be judged to have a higher ability to pay because her taxable income is double that of A. However A's economic income is at least equal to B's because he values his extra leisure time at least equal to the income forgone by working half time.

A problem remains even if the concept of ability to pay is applied on the basis of taxable income alone. In this case, the principle of vertical equity implies that B should pay more tax than A but it does not tell us how much more. It is difficult to translate the vague notion of vertical equity into practical tax design.

Progressive taxation

Many people believe that, in order to be equitable (ie 'vertically' equitable), the tax system needs to be 'progressive'.

Under a progressive tax system, the average tax rate increases with increases in the amount of income or consumption expenditure of the taxpayer. For example, under a progressive income tax system, individuals on low incomes pay a smaller proportion of their income in tax than individuals on higher incomes. By contrast, under a regressive tax system, the average tax rate decreases as income or expenditure increases.

Contrary to popular belief, a flat marginal rate of tax does not produce a regressive tax system. For example, if all incomes were subject to the same marginal tax rate, individuals on lower incomes would still pay less tax than those on higher incomes. The imposition of a flat marginal tax rate on income can also produce a progressive tax system when it is combined with a universal benefit or a tax-free threshold (or some form of low-income rebate). Similarly, the GST imposes a flat marginal rate of tax of 12.5 percent on most consumption spending. As a result, individuals who spend less pay less GST than individuals who spend more. By itself, a flat marginal rate of tax produces a 'proportional' tax system, not a regressive tax system. That is, under a flat rate of income or consumption tax, all individuals face the same average rate of tax. The GST is essentially a proportional tax since, over their lifetimes (leaving aside inheritances and bequests), individuals broadly spend what they earn.

Underlying the belief that the tax system should be progressive, or even more progressive than it is at the moment, is the view that a more equal distribution of incomes is desirable. As noted above, however, equalising incomes only improves 'equity' if one is motivated more by envy for individuals on high incomes than a desire to provide a safety net for the poor.

The weakness of the case for progressive taxation on equity grounds is elaborated in Buchanan and Hartley (2000) pp 70 - 184.

Assessing the actual impact of the tax and benefit systems

Despite the limitations of such studies, it may be helpful to examine the extent to which the tax and benefit systems appear to be redistributing income from the middle and upper income groups to those on lower incomes who are unable to help themselves.

This serves to focus public debate more on the actual rather than perceived effects of those systems. It also places the government in a better position to determine whether or not those outcomes are consistent with its policy objectives.

When assessing the equity of the tax and benefit systems, it is important to distinguish between:

- the legal incidence of taxes and benefits (ie the amounts of taxes and benefits that individuals are legally obliged to pay and entitled to receive respectively); and

- the actual economic incidence of those taxes and benefits (ie the amount of the tax paid by an individual that is actually borne by that individual, and the amount of the benefit received by an individual that is actually enjoyed by that individual).

The economic incidence of taxes and benefits can differ considerably from their legal incidence. Both taxes and benefits have the unintended effect of encouraging individuals to change their behaviour in order to minimise the amount of tax they have to pay and increase the amount of benefits they receive (eg by altering their decisions to work, consume, save, invest, produce and use resources). This shifts the actual economic incidence of taxes and benefits away from what was originally intended. These unintended behavioural changes not only reduce efficiency but also reduce the extent to which the tax and benefit systems are capable of redistributing income in the manner intended.

The operation of the market tends to reduce existing inequities in the tax system over time by reflecting taxes (and regulatory burdens) in asset values. If the government were to provide a tax concession for, say, forests, existing forest owners would reap a windfall gain and pay less tax than other people who are in a similar position in other respects. However, the concession would soon be reflected in the value of forests and forestry land, and subsequent investors would only obtain a normal return on their investment. Although there would be a perceived inequity in that new forest owners would appear to benefit from the tax concession, they would receive no economic benefit from it. The apparent inequity is eliminated by changes in asset values but the inefficiency that arises from an over-investment in forests from the nation's point of view would remain.

As a result, any subsequent attempts to improve the perceived equity of the tax system by removing longstanding inequities may actually reduce equity by imposing windfall losses on the new owners of concessionally taxed assets.

When assessing the equity of the tax and benefit systems, it is also important to consider their impact on inter-temporal equity. Ideally, the tax system should redistribute income in an equitable manner not only in the current income year but over time as well. In particular, it is important to ensure that the tax system has an equitable effect on the distribution of income over the lifetimes of individuals, and between generations.

It is often asserted that the tax reforms adopted since 1984 were inequitable. Such statements usually focus on changes in statutory rates of tax and ignore changes to tax bases. About half of the revenue raised by the introduction of GST was used to replace or reduce other indirect taxes. Beneficiaries were fully compensated for the impact on prices of GST. The reductions in income tax rates were more than offset by broadening the income tax base and by GST. The ratio of tax to GDP has increased by 10 percent since the reforms began. Almost all measures aimed at broadening the income tax base were borne, at least initially, by people on middle to upper incomes. The former concessions for savings and absence of tax on fringe benefits and higher taxes on companies are examples. We are not aware of any analysis of the distribution of incomes which attempts to account properly for the massive changes in the tax system since 1984. For that and other reasons, the analyses that have been performed should be treated with extreme caution.

2.2.3 Consistency with the government's broader economic and social policy objectives

In addition to achieving the government's equity objectives, it is also important to ensure that the tax system is consistent with the government's broader policy objectives.

The current tax system contains a number of provisions that appear to be directed at those broader objectives. These include:

- the concessional tax treatment currently accorded:
  - research and development;
  - film production;
  - forestry and petroleum; and
  - investment in certain depreciable assets which are eligible for a 20 percent loading on economic rates of depreciation;
- the excises on beverages containing alcohol and tobacco, which are intended to reduce consumption of those products and raise revenue to finance the external health care costs that consumption of those products are perceived to impose on the community; and
- the excise on petrol, which is used as a means of charging for road use and raising revenue to fund roads and general government expenditure.

The original policy intent of many existing tax concessions is not clear. In particular, it is often unclear whether those tax concessions are due to an explicit decision to reduce tax on certain activities or to practical difficulties in taxing affected activities.

2.2.4 Practical constraints and their implications for the design of the tax system

Information constraints

Information constraints have a profound effect on the determination of the role of the tax system and its design. For example, in theory it is possible to improve the efficiency of the tax system by applying different 'optimal' rates of tax to particular activities (ie 'Ramsey' taxation). This approach requires the highest rates of tax to be imposed on those activities that are relatively insensitive to tax and the lowest rates of tax to be applied to activities that are highly sensitive to tax.

Indeed, in theory it is possible to raise revenue in a manner that actually improves the overall efficiency of the economy. This involves the imposition of corrective taxes on those activities that impose external costs on the nation as a whole. Such 'optimal' taxes are capable of producing a 'double dividend' - raising revenue and improving economic efficiency.

In practice, however, the government's ability to improve the efficiency of the tax system through the introduction of such 'optimal' taxes is constrained by a lack of information. In order to set such 'optimal' rates of tax, it is necessary to have detailed information on:

- the sensitivity of economic decisions to differences and changes in tax rates (ie price 'elasticities' of demand and supply); and
- the precise nature and extent of any market failures the tax system is intended to correct.

In many cases, that information is not available. Even when it is available, it may not be sufficiently accurate to enable the calculation of accurate 'optimal' rates of tax. In addition, the collection of that information on a regular basis is likely to involve significant administration and compliance costs which will further reduce the potential for those 'optimal' tax rates to improve the efficiency of the tax system. Indeed, inefficiencies arising from inaccuracies in 'optimal' tax rates and high administration and compliance costs may more than offset any potential gains in efficiency to be derived from their implementation.

If different 'optimal' rates of tax are applied taxpayers are provided with an opportunity and incentive to lobby for more favourable treatment, thereby transforming the initial 'optimal' tax rates into a highly distorting set of taxes. For these reasons, successive New Zealand governments have been pursuing a much less informationally demanding approach to tax reform that involves:

- broadening the tax base, through the removal of explicit income tax concessions and the introduction of a broadly based GST;
- reducing statutory rates of income tax;
- applying more uniform rates of indirect tax (eg the flat rate of GST replaced the disparate rates of the former wholesale sales tax) and income tax.

Such an approach to tax reform requires much less information than that required to set different 'optimal' rates of tax. In particular, it has the potential to reduce the deadweight costs of taxation without the need to obtain detailed and accurate information on either the actual effective rates of tax applying to different activities or the sensitivity of those activities to changes in those effective tax rates. By contrast, in order to set 'optimal' rates of tax, access to such detailed and accurate information is essential.

Reducing the top statutory marginal tax rate can lower actual effective marginal tax rates, as well as differences in those tax rates. The implementation of lower and more uniform statutory rates of tax also enables the collection of a greater proportion of tax revenue using withholding taxes. This reduces administrative costs, decreasing the scope for evasion of tax on income subject to withholding, and cuts compliance costs by reducing the numbers of taxpayers required to file returns. More uniform rates of tax also limit the scope for splitting income among taxpayers such as family members who face different effective marginal rates of tax.

The existence of these information constraints does not mean that it is never desirable for the government to implement 'optimal' tax rates but it does mean that there should be compelling evidence that the benefits of doing so will exceed the costs involved. It is important, for example, to:

- avoid the design of tax regimes that are too informationally demanding;
- regularly review and reform existing tax regimes that seek to apply different rates of tax to particular activities to:
  - encourage certain 'desirable' activities in order to achieve the government's broader economic and social policy objectives (eg via the provision of tax concessions to encourage investment in certain activities);
  - discourage certain 'undesirable' activities (eg the excise taxes currently imposed on tobacco, alcohol and gambling); and
  - reduce the domestic cost of capital (eg the imposition of a lower rate of New Zealand tax on the income of non-residents than that applied to the income of residents);
- examine carefully any proposals to introduce new 'optimal' tax regimes (eg the implementation of so-called 'green' taxes such as a carbon charge to reduce greenhouse gas emissions).

It is important to recognise that information constraints also limit the extent to which it is possible to improve the efficiency of the tax system by broadening the tax base to include a wider range of economic income. In theory the income tax base should be 'comprehensive'. That is, it should recognise all gross income and related expenditure when they occur, as well as all changes in the values of all assets and liabilities as they accrue. This would ensure that the income tax system is 'neutral' across different productive activities and investments. However, it is impossible to obtain accurate information on the market value of many assets and liabilities and the extent to which those values change over time. This limits the extent to which the equity and efficiency of the tax system can be improved by expanding the tax base to include a wider range of income from capital, or by introducing, say, an annual wealth tax.

Conflicting objectives

Another significant constraint on tax policy development is the conflict that can arise between the various objectives of the tax system. One of the most common conflicts encountered in tax policy development is that between equity and efficiency. Although it is often possible to improve both, in some cases attempts to improve the equity of the tax system can reduce its efficiency. For example, the government's recent decision to raise the top personal tax rate in order to improve the perceived equity of the tax system has reduced its overall efficiency by:

- increasing the disincentive to work, save and invest;
- reducing the quality of investment, since taxpayers on the top marginal rate now have a greater incentive to invest in concessionally taxed assets, rather than assets that produce a higher rate of return to New Zealand;
- increasing the complexity of the tax system, since extensive amendments have had to be made to the Income Tax Act to reduce the scope for taxpayers on the top marginal tax rate to derive income in a form that is taxed at a lower rate; and
- increasing administrative and compliance costs, for example multiple rates of FBT have been introduced.

Conflict also arises between the various efficiency objectives of the tax system. As outlined in section 2.2.1, the efficiency objective is often described in terms of the desirable features that the tax system should posses. These include the ability to measure income accurately, simplicity, certainty, and low administrative and compliance costs.

While each of these features is desirable, in practice it is difficult to design a tax system that exhibits all of them. In trying to achieve one desirable attribute of an efficient tax system, another can be compromised. In particular:

- reducing compliance costs can increase the costs of administration;
- improving the accuracy of income measurement can increase the complexity of the tax system as well as administration and compliance costs; and
- altering the tax system to improve its efficiency can reduce certainty.

The conflict between the different objectives means that it is not possible to design a tax system that is ideal in terms of equity and efficiency. Any feasible tax system will be considered to be inequitable in some respects, and it will inevitably impose some deadweight costs on the community. In this regard it is important to note that increased efficiency leads to higher output and incomes over time. They are likely to be far more important to the overall welfare of people on low incomes than the advancement of static notions of equity.

Where conflicts arise the objective should be to reduce the total deadweight costs of taxation. This may involve an increase in some categories of deadweight costs and a reduction in others.

International considerations

International considerations also impose significant constraints on tax policy development in New Zealand.

In particular, it is important to recognise that as a small capital importing nation, New Zealand has:

- limited capacity to assess and collect tax on non-residents, since non-residents always have the option of investing in another jurisdiction that may impose a lower level of tax on their income; and

- limited ability to influence the tax regimes applying in other jurisdictions through *unilateral* changes to its tax system or participation in international fora.

As discussed further in section 4.2.5, these constraints have important implications for the design of the international tax regime that applies to the foreign sourced income of residents and the New Zealand sourced income of non-residents.

In view of the limited scope that New Zealand has to influence tax regimes in other jurisdictions through unilateral action, New Zealand has entered into a range of double tax agreements aimed at improving welfare by reducing the extent to which cross-border income flows are subject to multiple taxation. These agreements override New Zealand tax legislation and constrain the extent to which it is possible to alter domestic legislation without renegotiating those treaties.

3 PROBLEMS WITH THE CURRENT TAX SYSTEM

Having identified the principles that should govern tax policy development in section 2, this section uses those principles to evaluate how well the current tax system is performing its role of "... generating the government's revenue requirements at least possible economic cost, whilst supporting the government's equity objectives" (this is the government's 'Revenue Strategy' as set out in Budget 2000).

Our purpose here is not to undertake a comprehensive review of the current tax system. Such a review would be well beyond the scope of this submission. Rather, we seek to present our views on some of the main problems with the current tax system.

3.1 HOW EQUITABLE IS THE TAX SYSTEM?

As noted in section 2.1, the tax system is only one of number of policy instruments that the government uses in combination to achieve its equity objectives. Other important instruments include the social welfare system, the provision of subsidised goods and services, and government charges. As a result, when assessing the equity of the current tax system it is important to consider their combined interaction.

When considering the equity of the tax system, many individuals look no further than the schedule of statutory tax rates that apply to the income of individuals. At the moment, these rates are as follows:

- 19.5 cents in the dollar for income not exceeding $38,000;
- 33 cents in the dollar for income between $38,000 and $60,000; and
- 39 cents in the dollar for income above $60,000.

This schedule of statutory marginal tax rates produces average tax rates that increase as the incomes of individuals increase. That is, it produces a progressive personal income tax scale. This appears to suggest that the current income tax system is equitable since it conveys the impression that:

- individuals on the same income face the same rate of tax; and

- individuals on higher incomes face higher rates of tax.

As outlined below, however, individuals face far more complex schedules of average effective tax rates that vary considerably due to the complex interaction of the tax and benefit systems.

3.1.1 Individuals on low incomes can face much higher rates of tax than individuals on high incomes

The average effective tax rates applying to individuals on low incomes are reduced to some extent through the provision of a range of social welfare benefits.

Some of those benefits are provided directly via the tax system. For example, a variety of rebates are provided to individuals, including the low income rebate, a transitional tax allowance for certain full-time employees, and a child rebate. In addition, low-income families receive assistance via the family support tax credit, child tax credit (which used to be called the independent family tax credit), the family tax credit and the parental tax credit.

Once we allow for the effect of the low income rebate, the schedule of statutory effective marginal rates of income for those who qualify for it becomes:

- 15 cents in the dollar for income not exceeding $9,500;
- 21 cents in the dollar for income between $9,500 and $38,000;
- 33 cents in the dollar for income between $38,000 and $60,000; and
- 39 cents in the dollar for income over $60,000.

A range of social welfare benefits that are funded by tax revenue further reduces these effective marginal tax rates. For example, various social welfare benefits are provided to individuals including the domestic purposes, unemployment, sickness, widow's and invalid's benefits and the Accommodation Supplement. Individuals also receive a wide range of goods and services that are subsidised, including education and health services.

At the same time, however, the average and marginal effective tax rates imposed on the income of individuals are increased by a variety of regimes that are intended to target social welfare assistance to low-income earners. Those 'abatement' regimes reduce the benefits that individuals are paid as their income increases. This increases the effective marginal tax rates imposed on the income of those individuals to levels that are far higher than the rates of tax applying to individuals on much higher incomes. For example, individuals receiving the low income rebate, the domestic purposes benefit and the family support benefits can face marginal effective tax rates of over 90 percent, though such high effective marginal rates are relatively rare.

3.1.2 Individuals with the same annual income can face different tax burdens

Individuals with the same annual income can also face vastly different tax burdens depending on the nature of their activities and the form in which they derive their income. For example, individuals with the same annual income who undertake different activities will face various average and marginal effective tax rates depending on the amount of GST, FBT, excise tax, gift duty, gaming duty and government charges they pay, as well as differences in the benefits they receive. Similarly, individuals on the same incomes will face different average and marginal effective tax rates because of differences in the form in which they derive their income due to differences in the tax treatment of income from capital. For example, individuals who earn a greater proportion of their income in the form of non-assessable income from capital will face a lower effective marginal tax rate than individuals who earn a greater proportion of their income in the form of wages and salaries.

3.1.3 Individuals with the same lifetime taxable income can face different income tax burdens

The progressive income tax regime also imposes different income tax burdens on individuals who earn the same taxable income over their lifetimes (expressed in net present value terms) due to differences in their patterns of consumption and saving over their lives. A major problem with any income tax regime is that it discourages saving and investment relative to present consumption. A progressive income tax regime exacerbates this problem. That is, it imposes an even greater disincentive on individuals to save and invest more of their income in order to increase their future income.

In addition, since taxable income tends to increase with age, the progressive income tax regime also redistributes income from:

- the old to the young in any one year; and

- the later years of taxpayers' lives, when they are earning higher income, to the earlier years of their lives.

Since most individuals only spend a limited time on benefits, and eventually move on to moderate incomes, the tax and benefit systems act more to smooth out fluctuations in individuals' incomes over their lives rather than redistribute income from the rich to the poor. Indeed, individuals whose taxable income fluctuates from year to year, and who move into and out of the benefit system frequently over their lives, can end up paying much higher levels of tax over their lifetimes than individuals who earn the same amount of taxable income but at a more constant rate.

In summary, the ability of the current tax and benefit systems to improve equity by redistributing income from the rich to the poor is reduced by:

- the ability of individuals to supplement their taxable income in any year either by borrowing against their future income or by running down their existing savings, thereby increasing their current standard of living at the expense of their future living standards; and
- the extent to which individuals' taxable incomes vary significantly over their lives.

In effect, these two factors reduce the extent to which differences in the taxable incomes of individuals provide a reliable guide to permanent differences in their standards of living.

3.1.4 Individuals are compensated for deciding to work, save, and invest less

Although the taxable income of an individual depends to some extent on their innate ability to earn that income, it is also affected by their personal choices. Individuals frequently decide to forgo the opportunity to earn higher taxable income in order to pursue more leisure, have children, and live in their preferred locations.

As a result, although the tax and benefit systems compensate individuals who do not have the ability to earn sufficient income to meet their basic needs, they also compensate those individuals who choose to earn less taxable income than otherwise. Indeed, the progressive nature of the current income tax regime, and the generosity of the benefit system including New Zealand Superannuation (ie its extension far beyond the provision of a basic social safety net), encourages individuals to earn less taxable income and rely on increased government assistance to meet their needs.

In particular, the tax and benefit systems compensate those individuals who choose to:

- work less (due to the availability of unemployment benefits and the application of lower effective marginal tax rates to those individuals who earn less taxable income);
- save and invest less (eg due to the application of lower effective marginal tax rates on those individuals who choose to save and invest less);
- spend less on private employment, accident or health insurance (eg due to the provision of subsidised health services and accident compensation);
- have more children (eg due to the provision of child support); and
- invest less of their income in their own education and training and the education and training of their children (eg due to the provision of subsidised primary, secondary and tertiary education).

The redistribution of income to such individuals is not only inequitable but also highly inefficient. While the redistribution of income from the rich to the poor may improve equity, it encourages individuals to reduce their personal efforts to improve their standards of living and to become increasingly reliant on government assistance.

3.1.5 The GST regime is more equitable than many people believe

Although New Zealand's GST regime is widely regarded as an efficient source of tax revenue, and the Labour Party and the National Party support its retention, there are still people in the community who believe GST is an inequitable tax. Indeed, it appears that the perceived inequity of the GST regime was the main reason why the Alliance proposed, prior to the last election, to replace the GST with a financial transactions tax (FTT).

This perception that the GST regime is inequitable originates from the view that the burden of the GST regime falls disproportionately on the poor since they spend a greater proportion of their income than the rich. It is important to note, however, that such an argument fails to consider the relative equity effects of income and consumption taxes over taxpayers' lifetimes.

As noted above, the taxable incomes of individuals do not provide a particularly good indication of their standards of living due to:

- the variability of taxable income over individuals' lifetimes; and
- the ability of individuals to supplement their taxable income in any year by running down their savings, or borrowing against their future income.

By contrast, consumption expenditure may provide a more accurate measure of the standard of living of a taxpayer in any year to the extent that individuals tend to save and borrow to smooth out their consumption over their lifetimes (ie in accordance with the 'life cycle' hypothesis).

It is sometimes claimed that GST is a regressive tax. This is not true. GST is essentially a proportional tax in that a flat rate of tax is applied to all taxable consumption spending. Moreover, on the introduction of GST people on low incomes were fully compensated for its impact on prices through benefit adjustments and family assistance. In contrast, people with savings, predominantly those on higher incomes, suffered a windfall loss as such savings became subject to GST when spent on taxable goods and services.

Rather than reduce the equity of the tax system, it is possible that the decision to reduce rates of income tax, broaden the income tax base and collect a greater proportion of revenue using GST has improved the overall equity of the tax system.

3.1.6 Much of the revenue raised from the taxation of higher income individuals is redistributed back to those individuals in the form of subsidised goods and services

Many people presume that the income tax paid by individuals on higher incomes goes to funding benefits for the poor. Unfortunately, this is not entirely the case. As outlined below, households in the bottom two quintiles receive on average more in government benefits and services than they pay in taxes whereas other households pay more in taxes than they gain in services and benefits. Nevertheless, a significant proportion of the revenue collected from high-income households is actually 'churned' back to those households in the form of subsidised services.

As set out in Table 1, the preliminary results of research reported by Cox (forthcoming) suggest that households with market incomes in the two highest quintiles receive 76 percent of market incomes and pay 74 percent of direct taxes such as income tax and 68 percent of all taxes, but also receive 28 percent of all government benefits. This includes 51 percent of non-cash education benefits, 49 percent of student allowances and bursaries and 34 percent of government health expenditure.

In particular, about one third of all direct tax revenue raised is returned in the form of benefits to households with market incomes in the two top quintiles. This suggests that there is considerable 'churning' of tax revenue since 74 percent of that direct tax revenue is raised from households with market incomes in the two top quintiles.

Table 1: Average incomes, benefits and taxes, 1997/98 households ranked by market income

	Lowest 20 percent	*Second Quintile*	*Third Quintile*	*Fourth Quintile*	*Highest 20 percent*	*All households*
Market income	1,331 (1)	14,375 (7)	35,011 (16)	56,519 (26)	106,313 (50)	42,710 (100)
Direct taxes	2,690 (5)	4,089 (7)	7,867 (14)	13,143 (24)	27,801 (50)	11,118 (100)
Indirect taxes	2,277 (9)	3,455 (14)	4,797 (19)	5,705 (23)	8,582 (35)	4,964 (100)
Total taxes	4,967 (6)	7,544 (9)	12,664 (16)	18,848 (23)	36,383 (45)	16,082 (100)
Benefits and family assistance	4,726 (33)	5,547 (38)	2,631 (18)	1,115 (8)	467 (3)	2,897 (100)
New Zealand Superannuation	8,784 (55)	4,496 (29)	1,090 (7)	647 (4)	619 (4)	3,127 (100)
Student allowances and bursaries	6 (0)	536 (28)	435 (23)	475 (25)	466 (24)	384 (100)
Total government health expenditure	4,135 (24)	3,903 (23)	3,190 (19)	2,994 (18)	2,749 (16)	3,394 (100)
Other government education expenditure	2,093 (12)	2,920 (17)	3,655 (21)	4,024 (23)	5,008 (28)	3,530 (100)
Total government expenditure (a)	19,744 (30)	17,402 (26)	11,001 (17)	9,255 (14)	9,309 (14)	13,332 (100)
Final income	16,108 (8)	24,233 (12)	33,348 (17)	46,926 (23)	79,239 (40)	39,960 (100)

Source: Cox (forthcoming)

A better indication of the amount of 'churning' that is occurring can be obtained by ranking households according to the amount of taxes they pay, rather than by the amount of market incomes they receive. Using this approach, Cox (forthcoming) estimates that households in the two highest quintiles of taxpayers (ie those households paying the most tax) received

$4,283m (32.6 percent) of total spending on education, health and superannuation in 1997/98. This comprised:

- $2,193m (51.5 percent) of education spending (student allowances and other education expenditure);
- $1,615m (35.1 percent) of health spending; and
- $474m (11 percent) of spending on superannuation.

Altogether, 19 percent of all tax revenue, and 28 percent of direct tax revenue, was returned to the two highest quintiles of taxpayers in 1997/98 in the form of education, health and superannuation payments. This 'churned' education, health and superannuation expenditure amounted to 4.3 percent of GDP in 1997/98. If 'churned' benefits are also included, this figure rises to 5.2 percent of GDP.

Cox (forthcoming) also notes that the top three quintiles of taxpayers received $6,324m in health, education and superannuation benefits in 1997/98 (48.1 percent of all such assistance). In particular, this broader group received 72 percent of all education assistance, 54 percent of all health assistance, and 17.6 percent of all superannuation assistance. Altogether, around 29 percent of all tax revenue, and 42 percent of all revenue collected from direct taxation, is returned to the top three quintiles of taxpayers in the form of education, health and superannuation benefits. In addition, around 84 percent of all tax revenue collected, and 87 percent of direct tax revenue, is collected from these three highest quintiles of taxpayers.

This significant 'churning' of government revenue is neither equitable nor efficient. In the course of collecting that tax revenue through the tax system, and redistributing it back in the form of subsidised services, a significant portion of the income of those individuals is lost in deadweight costs. Other inefficiencies arise from the weak incentives that tax-funded education and health providers face.

3.2 HOW EFFICIENT IS THE TAX SYSTEM?

3.2.1 The income tax regime discourages saving and investment

One of the major problems with any income tax system is that it acts as a disincentive to saving and investment and, as noted in section 2.2.1, the extent of that disincentive is greater the higher the effective marginal tax rates applying to income.

Over the last two decades, considerable progress has been made in reducing the statutory marginal tax rates applying to income. As noted in Figure 1, the top personal marginal tax rate has been reduced from 66 percent in the early 1980s to 33 percent over most of the 1990s, but was increased to 39 percent in 2000. Similarly, the company tax rate has been lowered from its level of 45 percent over most of the 1970s and early 1980s to its current level of 33 percent which has prevailed since 1988.

It is important to note, however, that those reductions in statutory marginal rates of income tax were made possible by a significant broadening of the income tax base as well as the introduction of the GST.

Figure 1: New Zealand's top personal and company tax rates

Source: Moes (1999)

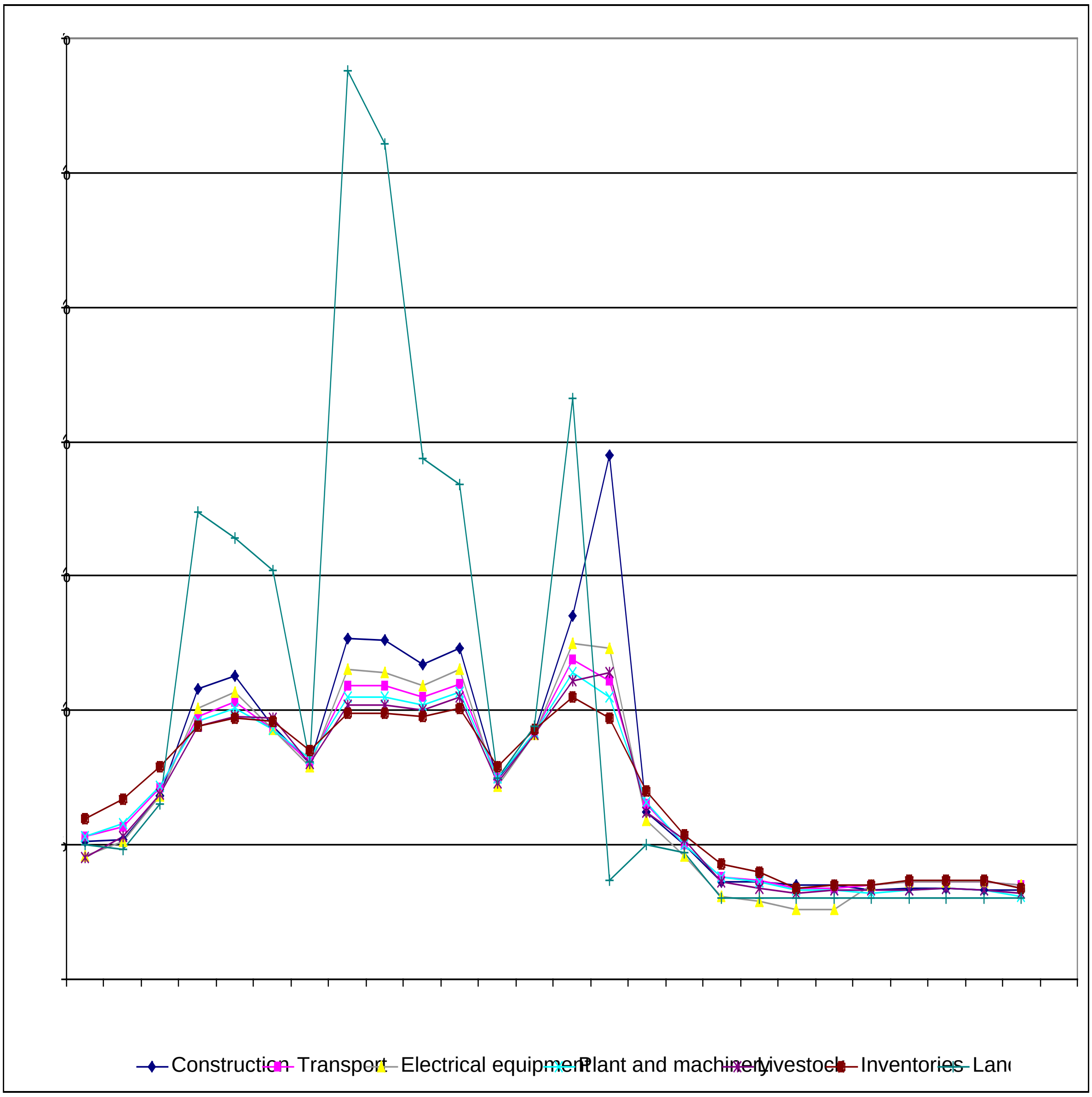
The introduction of GST significantly reduced the amount of revenue that needed to be collected via the income tax system. It also reduced the overall disincentive to save and invest, since such a consumption tax does not reduce the return that individuals derive from saving and investing. However, the broadening of the income tax base has tended to increase the disincentive to save and invest arising from any given level of tax.

The disincentive for foreign investors to invest in New Zealand has been reduced to some extent by the subsequent introduction of the approved issuer levy (AIL) and the foreign investor tax credit (FITC) regimes. Their objective is to reduce the domestic cost of capital by reducing the amount of New Zealand tax imposed on the New Zealand sourced income of non-residents. They target those investments that are expected to be the most sensitive to New Zealand tax - debt investment and equity investments where the non-resident is unable to claim a credit for the amount of New Zealand tax paid.

The actual effective marginal tax rates applying to saving and investment in New Zealand are extremely difficult to determine in view of the myriad different factors that influence them. It is possible, however, to gain some idea of those rates through the use of simplified models that examine the effect of a number of key features of the tax system under a range of simplifying assumptions. Such models also enable broad comparisons to be made of the likely effective marginal tax rates applying in other jurisdictions.

As indicated in Figure 2, research conducted by Moes (1999) suggests that the overall effective marginal tax rates on income from construction, transport, electrical equipment, plant and machinery, livestock, inventory and land declined over the period 1986 to 1998.

Figure 2: Overall effective tax rates (world rate of return 15%)



Source: Moes (1999)

Similar research conducted by Arthur Andersen (1998) indicates that the overall effective marginal tax rates applying to different forms of investment in New Zealand are relatively low in relation to those applying in other jurisdictions (see Table 2).

Table 2: Marginal effective tax rates at country-specific personal tax rates (percent)

Country	*Personal tax rate*	*Plant*	*Industrial buildings*	*Land*	*Inventory*	*R&D*	*Mining*
Australia	47	39.3	45.6	45.7	46.5	-90.3	33.2
Canada-manufacturing	54	45.1	51.5	52.3	53.6	na	43.4
Canada- other	54	46.1	50.5	51.6	53.4	na	32.5
Chile	45	41.8	40.8	44.5	44.8	36.9	39.3
France	61	55.2	54.3	59.9	60.5	21.5	49.1
Germany	56	51.3	50.8	52.9	55.6	43.2	46.6
Ireland-manufacturing	48	46.4	46.9	47.7	47.9	40.4	33.7
Ireland - other	48	42.3	43.8	46.9	47.6	13.4	10.5
Japan	65	64.1	59.7	63.8	64.5	na	57.3
Netherlands	60	59.2	59.0	59.1	59.6	44.5	53.8
New Zealand	33	30.1	33.0	27.7	32.4	6.6	-65.7
Singapore	28	11.3	23.4	26.8	27.5	-7.0	6.3
Sweden	30	22.5	27.1	25.7	29.5	7.9	15.7
Taiwan	40	37.2	39.4	39.0	39.6	na	31.7
United Kingdom	40	35.1	35.0	38.8	39.5	2.1	28.2
United States	47	38.3	42.1	45.3	46.1	16.9	-2.5

Notes: All assumptions as per Table 1 of Arthur Andersen (1998), other than personal tax rate. Personal tax rates are the rates applying to dividends received by individual taxpayers in each country's top income bracket. These rates do not include social security contributions or state / provincial taxes at the personal level.

Source: Arthur Andersen (1998)

It is important to note, however, that these overall effective tax rate figures do not provide a particularly good indication of the effective marginal tax rates applying to saving and the effective marginal tax rates applying to investment.

Table 3 outlines the results of the Arthur Andersen research into the effective marginal tax rates that the tax regimes in various jurisdictions apply to investment. It shows that for a given top personal income tax rate (47 percent in this case), the New Zealand tax regime tends to apply lower effective marginal tax rates on investment than the tax regimes in other jurisdictions.

Table 3: Effective tax rates for investment (percent)[(a)]

Tax system	*Plant*	*Buildings*	*Land*	*Inventory*	*R&D* (b)	*Mining*
Australia	17.8	24.3	22.5	29.6	-128.3	7.0
Canada - manufacturing	39.7	42.8	43.8	46.6	na	-18.1
Canada - other	49.9	53.2	54.2	56.9	na	-48.9
Chile	17.3	15.8	22.1	22.5	9.1	12.9
France	32.1	31.1	40.9	41.6	-12.9	20.5
Germany	19.5	18.4	25.6	24.3	3.1	9.9
Ireland - manufacturing	12.1	12.6	14.9	15.2	0.5	-9.3
Ireland - other	41.0	42.5	46.5	47.0	2.2	8.9
Japan	67.3	65.0	68.2	66.7	na	58.8
Netherlands	52.0	51.3	53.0	51.4	32.6	43.9
New Zealand	17.0	17.8	10.7	21.7	-15.9	-181.9
Singapore	0.9	13.3	21.0	21.7	-25.6	-6.4
Sweden	35.4	38.5	40.4	41.9	20.7	28.1
Taiwan	17.1	18.7	21.4	18.5	na	8.6
United Kingdom	23.3	22.7	29.5	30.2	-25.6	13.5
United States	44.6	47.7	51.4	49.6	24.6	-16.6

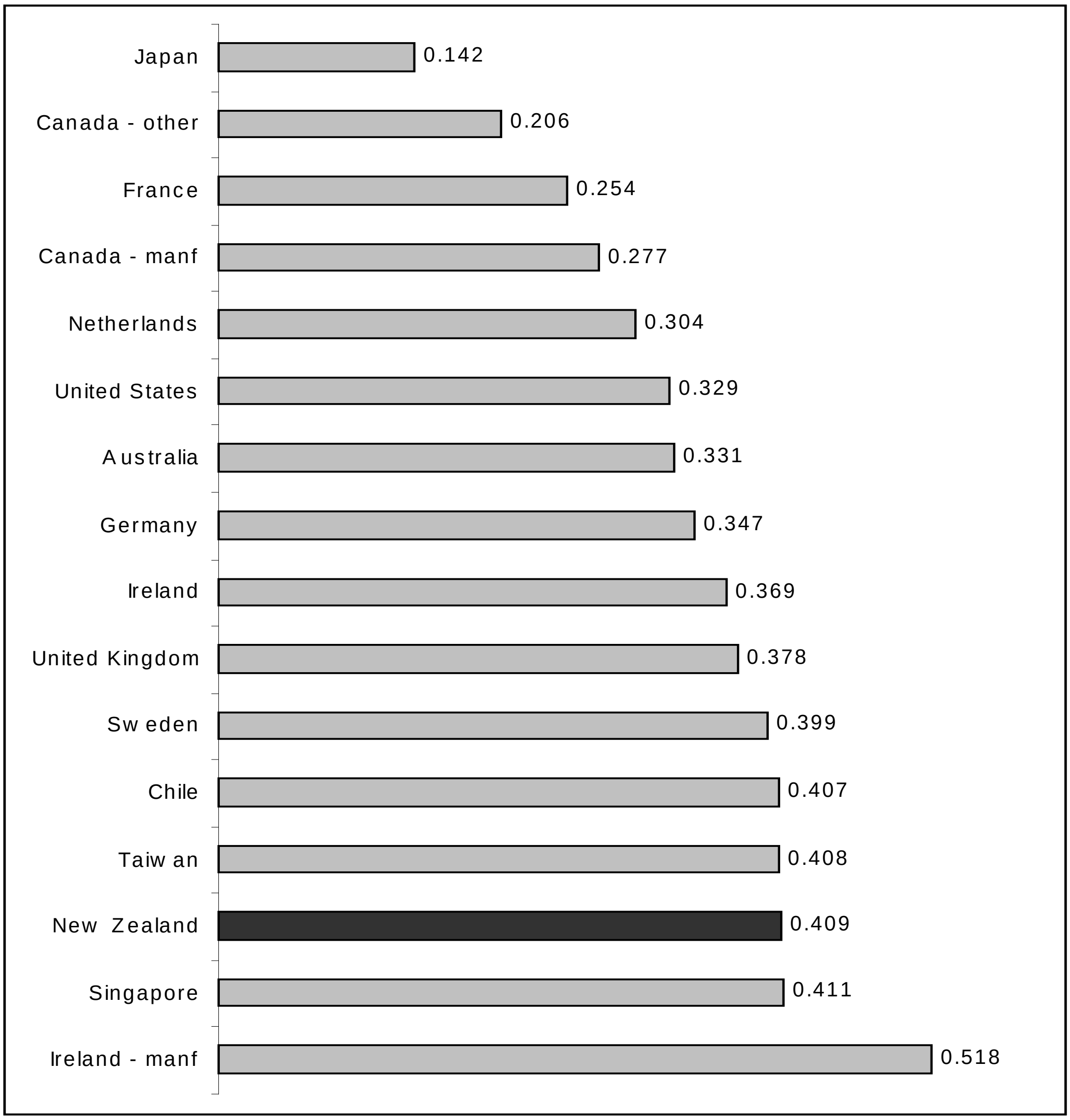
Notes: (a) Results assume two percent inflation, assets financed with a mixture of 35 percent debt and 65 percent equity. Table assumes income is distributed immediately as interest and dividends to individuals on the top Australian tax rate of 47 percent.

(b) na in respect of R&D means the calculated effective tax rate on investment is misleading.

Source: Arthur Andersen (1998)

By contrast, Figure 3 indicates that the New Zealand tax system can impose a higher effective tax rate on savings for a given top personal tax rate than the tax regimes applying in other jurisdictions. Tax systems, like New Zealand's, that impose the lowest effective marginal tax rates on investment tend to impose the highest effective tax rates on saving.

Figure 3: Effective marginal tax rates on saving



Source: Arthur Andersen (1998)

3.2.2 The current tax system reduces the quality of investment

Ideally, the New Zealand tax system should raise revenue without reducing the quality of investment decisions. That is, the tax system should not alter the choices that New Zealand investors make between alternative domestic and foreign investments and the choices that foreign investors make between alternative New Zealand investments.

Once again, however, although considerable progress has been made over the last two decades in developing a more neutral investment environment, there are still significant differences in the effective marginal rates of New Zealand tax applying to alternative investments as indicated in Table 3 (see also Gordon and Tchilinguirian (1998) for an outline of the different effective marginal tax rates applying to physical, human and R&D capital in OECD countries). For example, the effective tax rates applying to mining and research and development are significantly less than those applying to investments in plant, buildings, land and inventories. These differences in effective marginal tax rates distort investment decisions and reduce the overall quality of investment.

The current tax system distorts patterns of domestic investment

In particular, the pattern of domestic investment is distorted by significant differences in the effective marginal tax rates applying to income from alternative investments. Those differences in effective marginal tax rates arise from:

- differences in the tax treatment of different forms of income due to:
  - the exclusion of certain forms of income from capital from the tax base (eg gains on the sale of property not acquired for the purpose of sale);
  - differences in the timing of recognition of different types of income and expenditure (eg the income from capital gains on the sale of property is recognised when it is realised, but the income from financial arrangements and investments in controlled foreign companies and foreign investment funds is recognised as it accrues);
  - the ability to claim tax depreciation rates for certain types of capital equipment that are 20 percent higher than actual economic rates of depreciation;

- the difference in tax treatment of debt and equity (interest payments are deductible for income tax purposes, whereas dividends are not and must be paid out of after-tax income);
- differences in the income tax treatment of different entities (eg Maori authorities, qualifying companies, mutual associations and cooperatives, and charities); and
- differences in the GST treatment of different activities (eg the absence of GST on financial services and most imported services).

Some of these differences are due to practical problems associated with the assessment and collection of tax on certain types of activities. For example, it is clearly not feasible to assess and collect tax on all forms of income as it accrues. Similarly, it is not possible to assess and collect GST on certain types of activities such as the provision of financial services. In addition, there are practical difficulties associated with the assessment and collection of tax on many imported services and 'digital goods' imported by final consumers via the Internet or otherwise (eg computer software, music, books, magazines and films).

By contrast, other differences are due to explicit decisions made by past governments to use the tax system as a means of:

- encouraging certain 'desirable' activities; and
- discouraging certain 'undesirable' activities.

Unfortunately, often it is not clear to what extent the concessional tax treatment of certain activities is due to the practical difficulties associated with taxing those activities as opposed to a deliberate decision by the government to assist or deter certain activities. For example, it is not clear to what extent the current tax treatment of forestry and petroleum mining is due to practical problems with income measurement as opposed to an explicit decision to assist those activities via tax concessions. Although there are practical difficulties associated with the taxation of these activities, it is far from clear that allowing immediate deductions for capital expenditure is the best solution to them.

We believe the Review has an important role to play in affirming the view that the tax system should, as far as feasible, tax all activities and classes of entities on a neutral basis. It should also identify those activities that are currently subject to concessional tax treatment and determine the extent to which those concessions arise from either:

- explicit government policies aimed at subsidising particular activities or entities; or
- practical income measurement problems.

In particular, as discussed further in section 4, we believe the Review should be recommending the abolition of tax concessions to the greatest extent possible given the practical limitations of income measurement.

The current international tax regime distorts the foreign investment decisions of residents

We believe that differences in effective marginal rates of tax that New Zealand applies to the income that New Zealand investors derive from alternative foreign investments should be addressed by the Review. The disparate effective tax rates applying to the foreign investment income of residents arise from the controlled foreign company (CFC), foreign investment fund (FIF), dividend withholding payment (DWP), underlying foreign tax credit regime (UFTC), and the ability of individuals to claim credits for foreign tax.

Residents who invest in non grey-list countries are taxed on their income as it accrues under the provisions of the controlled foreign company (CFC) and foreign investment fund (FIF) regimes. The CFC regime applies to the income of New Zealand residents that have an interest of 10 percent or greater in a controlled foreign company. Under that regime, the income of the foreign company is recalculated under New Zealand income tax rules and a proportion of that income is attributed to the New Zealand shareholder on the basis of his or her level of income interest in that company. Income from investments not caught by the CFC regime is subject to the provisions of the FIF regime which, once again, taxes that income as it accrues, rather than when it is distributed to the New Zealand investor.

By contrast, residents who invest in grey-list countries are not subject to the provisions of the CFC and FIF regimes on most forms of investment and the income from those investments is only taxed when it is distributed. However, the FIF regime does apply to certain investments in life insurance and superannuation funds in grey-list countries.

The effective rates of New Zealand tax applying to income from those foreign investments is further complicated by the provision of underlying foreign tax credits to companies and foreign tax credits to individuals.

The current international tax regime has an uncertain effect on the quality of non-resident investment in New Zealand

New Zealand also imposes different effective marginal tax rates on the income that non-resident investors derive from different types of New Zealand investments. These different effective tax rates arise due to:

- differences in the tax treatment of non-resident owned companies located in New Zealand. A New Zealand subsidiary of a non-resident company is taxed at a rate of 33 percent on its worldwide income and its distributions to its parent company are also subject to non-resident withholding tax (NRWT). By contrast, a New Zealand branch of a non-resident company is liable to New Zealand tax on its New Zealand sourced income at a rate of 33 percent but it is not taxed on its distributions to its head office offshore;
- differences in the rates of non-resident withholding tax applying to different forms of income (dividend income is subject to non-resident withholding tax at a rate of 30 percent and interest income is subject to tax at a rate of 15 percent);
- differences in the treatment of non-residents depending on whether they are located in a country that has a double tax treaty with New Zealand (if so the rates of NRWT are reduced to 15 percent on dividend income and 10 percent on interest income);
- the operation of the FITC, which in effect provides the non-resident investor with relief from New Zealand income tax and NRWT;
- the operation of the AIL regime, which in effect reduces the effective rate of non-resident withholding tax imposed on the interest income of non-residents to around 1.34 percent; and
- the presumption that dividend income is sourced from the country in which the company paying the dividend is resident.

Some of these differences in tax treatment are intended to reduce the domestic cost of capital (eg the FITC and AIL regimes), whereas other differences are due to the practical difficulties associated with measuring and collecting tax on the income that non-residents derive from their New Zealand investments.

The precise effect that these differences in tax treatment have on the quality of non-resident investment in New Zealand is uncertain.

The absence of GST on imported services and 'digital' goods is encouraging inefficient patterns of consumption, production and resource use

Although GST is imposed on most imported goods, most imported services are not subject to GST with the exception of freight and insurance services associated with imported goods.

This absence of GST on imported services reflects the practical difficulties associated with the imposition of GST on them and the fact that when GST was introduced there was only a limited volume of imported services supplied direct to final consumers. Since trade in services was limited by a variety of legal and technological constraints, most services tended to be consumed in the countries in which they were produced.

Since the introduction of GST, however, the deregulation of the telecommunications and financial services markets in New Zealand, coupled with rapid advances in communication and computer technology, mean that New Zealander consumers and businesses can now import a wide range of services that have been produced offshore.

Similarly, rapid advances in telecommunication and computer technology now enable New Zealand consumers and businesses to import a variety of 'digital' goods such as computer software, music, movies, newspapers and magazines free of GST. Although these imported goods are legally liable to GST, they typically escape GST since they can be imported directly via the Internet and do not have to clear Customs.

As noted in the discussion document *GST: A Review* which was released in March 1999 (IRD 1999a), the absence of GST on these imported services and 'digital goods' reduces the overall efficiency with which the GST regime raises revenue since it:

- erodes the GST tax base;

- encourages inefficient patterns of consumption, by discouraging the consumption of domestically produced services in favour of imported services; and
- encourages inefficient patterns of production and resource use in New Zealand by:
  - discouraging the domestic production of services and digital goods, since domestic producers may not be able to pass on GST to consumers who are able to switch to imported services that are not subject to GST; and
  - discouraging the use of domestically produced services and digital goods by those New Zealand businesses that are either unable to claim GST input tax credits or are unwilling to incur the compliance costs associated with claiming them.

3.2.3 High effective marginal tax rates discourage beneficiaries from re-entering the workforce

As noted in section 3.1.1, many individuals receiving benefits face very high effective marginal tax rates as a result of the abatement of those benefits as their income rises.

These high effective marginal tax rates act as a significant disincentive for individuals to move off benefits and re-enter the workforce. Once in the workforce they discourage beneficiaries from increasing their work effort. That is, they tend to lock individuals into benefit dependency.

3.2.4 Increasing the top personal tax rate has reduced New Zealand's ability to attract and retain skilled labour

When setting its tax rates, New Zealand needs to take into account not only the international mobility of capital but also the increasing international mobility of labour.

The government's recent decision to lift the top marginal tax rate appears to have been made with little regard for its adverse effects on New Zealand's ability to attract and retain skilled labour. As skilled labour becomes more internationally mobile, the government's ability to impose relatively high taxes on the incomes of those individuals is reduced. Unless highly skilled, internationally mobile, individuals are offered after-tax rates of pay comparable with what they would be able to earn in other jurisdictions (after allowing for relocation costs etc), they may decide to leave New Zealand. This means that if the government imposes relatively high rates of tax (by international standards) on the income of those individuals, they may be unwilling to continue to work in New Zealand unless New Zealand employers are willing to pay them higher pre-tax incomes to compensate for those higher taxes. In other words, much of the burden of those higher rates of tax may fall on New Zealand employers in the form of higher labour costs, thereby reducing their ability to compete in both the markets for their products and their inputs.

Relatively high tax burdens and the poor performance of the economy are contributing to the migration of New Zealand citizens, particularly those with skills. The number of long-term departures of New Zealanders almost doubled in the last decade, increasing from 30,600 in 1991 to 58,680 in 2000. As the number of returning New Zealanders remained relatively stable there was a four-fold increase in the net outflow of citizens from 6,010 in 1991 to 26,600 in 2000.

In the five years to 2000, there was a net loss of 135,000 New Zealanders, a number larger than the total population of the Taranaki region. This migration loss has been largely offset by a net inflow of citizens of other countries.

The New Zealand Institute of Economic Research (NZIER 2000) reports that since 1996 there has been a steady increase in net migration of skilled New Zealanders and of people aged 25 to 34 . Low skilled workers also appear to be mobile, making up over 50 percent of all New Zealanders leaving the country for the long term (Sundakov 1999).

The government seems to take some comfort from the fact that New Zealand's top marginal tax rate of 39 percent appears to compare favourably with Australia's top marginal rate of 47 percent for income over $50,000 and the 40 percent rates prevailing in the United Kingdom and the United States.

However, these statutory marginal tax rates are misleading to the extent that they fail to take into account:

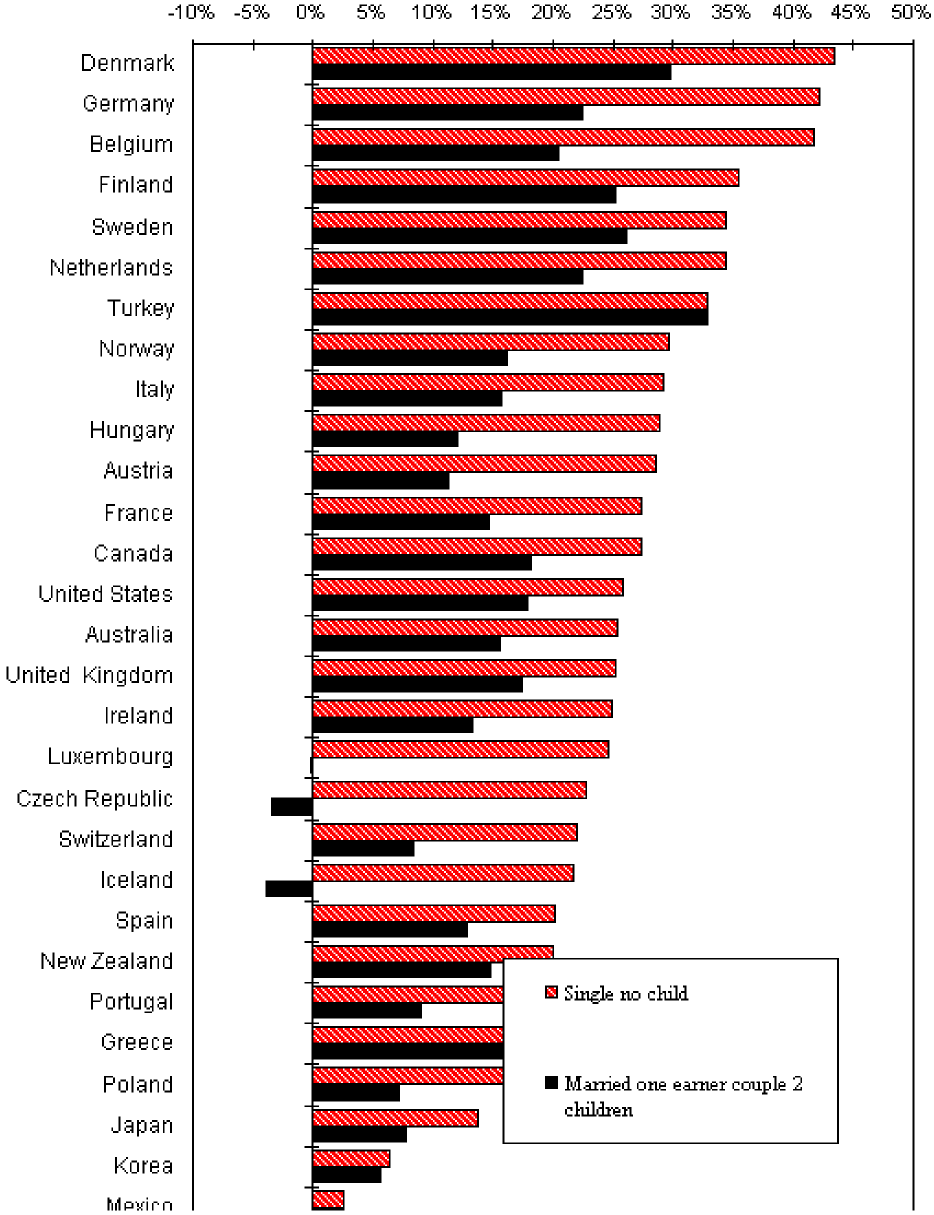
- the more generous tax-free thresholds that apply in other jurisdictions;
- the concessional tax rates applying to superannuation contributions;

- the trend in many OECD countries (Belgium, the Czech Republic, Greece, Hungary, Italy, Poland and the Nordic Countries) to introduce low flat rates of tax on certain forms of income from capital, particularly interest and dividend income (Martin and Bowers 2000);
- differences in rates of consumption tax, or differences in the consumption tax base. Australia's GST is levied at 10 percent and applies to a much narrower range of goods and services than New Zealand's; and
- the proposed reduction in the top US marginal tax rate to 33 percent.

Some indication of the average tax rates imposed on the labour income of average production workers is provided by the OECD's report on *Taxing Wages in OECD Countries 1998/99* (OECD 1999b). As indicated in Figure 4, the average tax rate imposed on the labour income of a single average production worker is lower in New Zealand than in most countries. However, although the average tax rate imposed on an individual who is married with two children is also lower than in many countries, it is similar to that prevailing in Australia. Once again, it is important to note that these figures do not include the effects of other taxes such as GST.

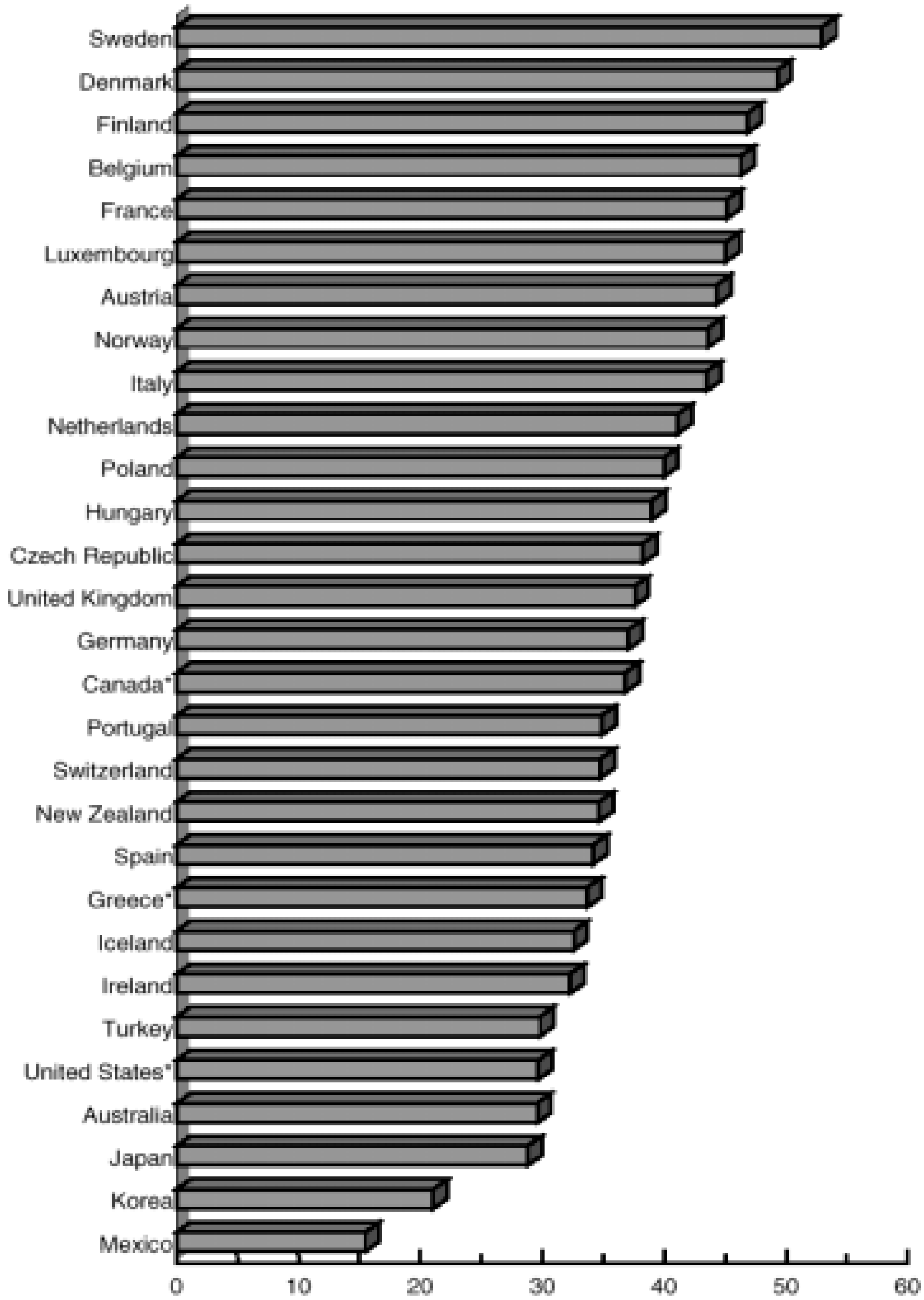
A further indication of the relative tax rates applying in different jurisdictions can be obtained by examining the tax to GDP ratios in those jurisdictions. As indicated in Figure 5, the tax to GDP ratio in New Zealand is still higher than that in many other OECD nations, particularly Australia.

Figure 4: Income tax plus employee social security contributions less cash benefits by family-type (as percentage of gross wage), 1998



Source: OECD (1999b)

Figure 5: Total tax revenue as a percentage of GDP 1998



Source: OECD (1999c)

3.2.5 The costs of raising tax revenue are still high and are rising due to the increasing flexibility of the New Zealand economy

As noted in section 2.2.1, effective tax rates and differences in effective tax rates are not the only factors that influence the magnitude of the deadweight costs of taxation. Another important factor is the sensitivity of decisions to work, save, consume, produce and invest to those high and disparate effective marginal tax rates. Reductions in tax rates, and disparities in tax rates, will tend to reduce the deadweight costs of taxation. However, if there are increases in the sensitivity of economic decisions to tax rates and differences in those tax rates, then the overall deadweight costs of taxation might increase rather than fall.

Consideration of the sensitivity of economic decisions to taxation is particularly important in New Zealand given the extensive range of reforms that have been implemented over the last decade to open up the economy to increased international competition and to deregulate the domestic economy. Those reforms, which were essential to improving economic efficiency and national welfare, have made the New Zealand economy much more responsive to changes in prices and relative rates of return than it was in the late 1970s. That is, resources are now much more mobile within the economy than they were in the past. Extensive economic reforms in other jurisdictions have also opened up the world economy, making financial, physical and human capital much more mobile between jurisdictions.

In 1992, the NZBR commissioned Professor Erwin Diewert and Dr Denis Lawrence to undertake a study of the deadweight costs of taxing labour income and consumption in New Zealand (Diewert and Lawrence 1994).

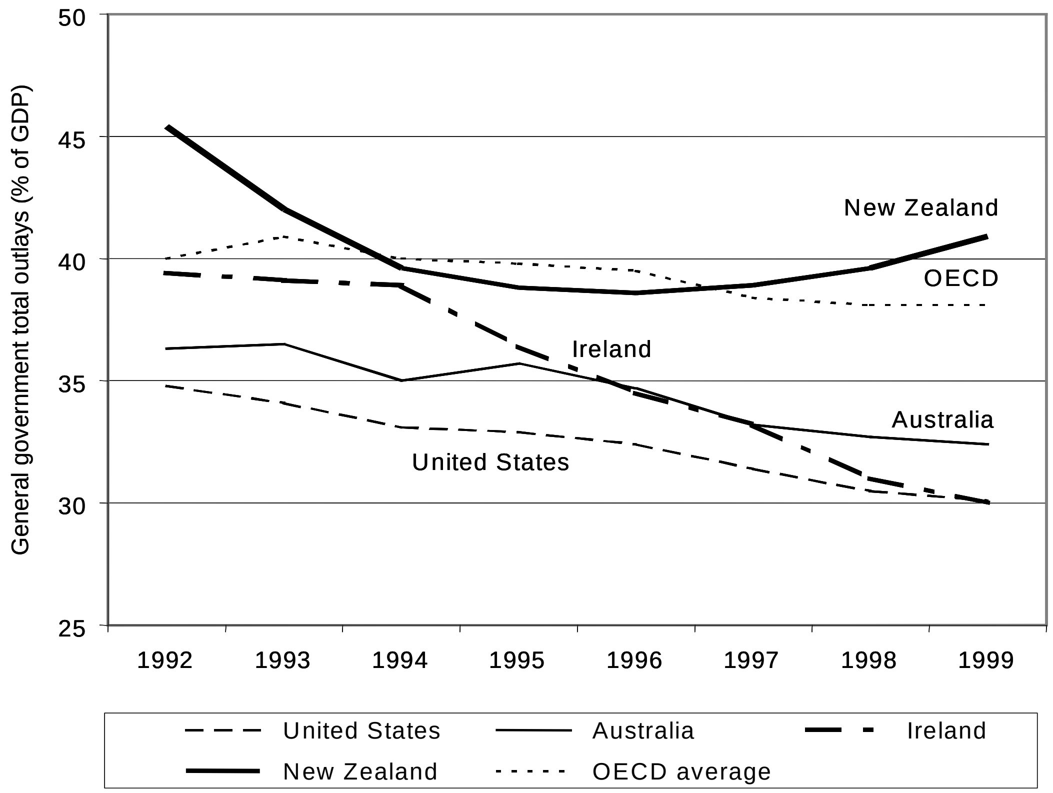
In brief, they found that the deadweight costs associated with raising the last dollar of revenue from the taxation of labour income had increased from 5 percent (ie 5 cents) in 1972 to over 18 percent (ie 18 cents) in 1992. That is, it cost New Zealand around $1.18 in 1992 to raise the last dollar of tax on labour income.

Similarly, the deadweight cost of raising the last dollar of revenue from the taxation of consumption (ie all indirect taxes other than property tax and import duties) was found to have increased from 5 percent (ie 5 cents) in 1972 to around 14 percent (ie 14 cents) in 1992.

That is, it cost New Zealand around $1.14 in 1992 to raise the last dollar of revenue from the taxation of consumption.

These increases in deadweight costs were the combined result of both a significant increase in rates of tax over the period of analysis and an increase in the sensitivity of economic decisions to those tax rates. It is important to recognise that those estimates understate the deadweight costs of taxation since they do not include either the deadweight costs of taxing income from capital, or administrative and compliance costs. Once those additional deadweight costs are taken into account, it seems likely that the total cost of raising an additional dollar of tax revenue is well over $1.30. These costs also underestimate the costs of redistributing income in New Zealand since they do not take into account the additional deadweight costs arising from the provision of benefits, including the administrative and compliance costs associated with the provision of those benefits.

Figure 6: Recent trends in government spending in selected OECD countries



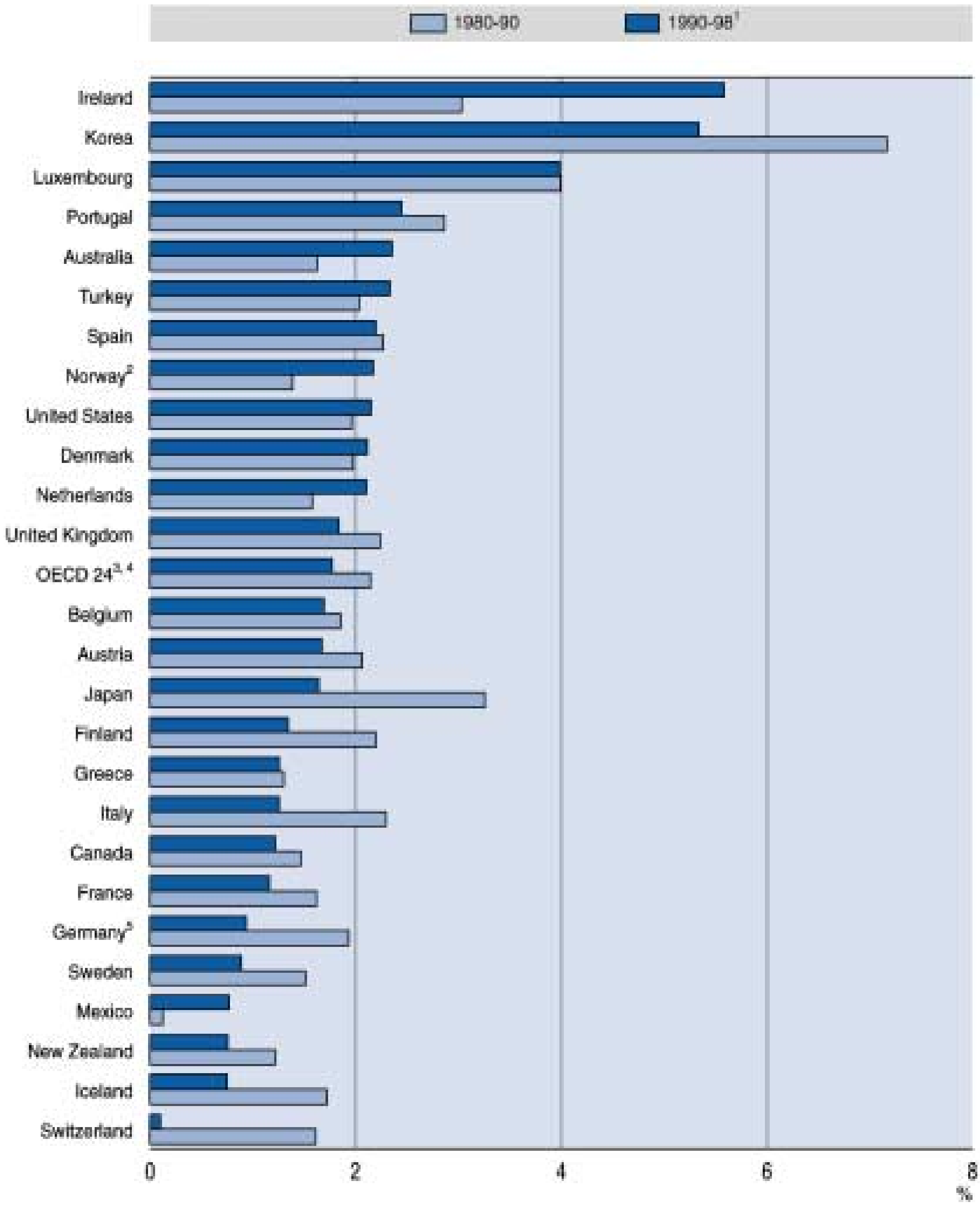
Source: Bates (forthcoming)

More recently, Treasury commissioned Professor Diewert and Dr Lawrence to undertake a study of the deadweight costs of taxing income from capital. A key issue in that study is the extent to which the deadweight costs of taxing income from capital in New Zealand are also increasing despite reductions in tax rates and differences in tax rates. It seems highly likely that the deadweight costs of revenue derived from taxing income from capital are also rising due to the increasing flexibility of the New Zealand economy.

Despite the increasing deadweight costs of raising an additional dollar of tax revenue, government spending has continued to increase, thereby increasing the total deadweight costs imposed on the nation as a whole. As noted by Bates (forthcoming) and set out in Figure 6, during the last few years government spending in New Zealand has moved against the trend in most other OECD countries. After falling in the early 1990s, general government total outlays increased from 38.6 percent of GDP in 1996 to 40.9 percent in 1999.

As a result, it is hardly surprising to find that New Zealand's economic growth performance over the last two decades, with the exception of the period in the early to mid-1990s following New Zealand's major reforms, has been poor in relation to other OECD countries as indicated in Figure 7.

Figure 7: Trends in GDP per capita



Source: OECD (2000b)

4 OPTIONS FOR REFORM

4.1 HOW CAN WE IMPROVE THE EQUITY OF THE TAX SYSTEM?

The terms of reference for the Review place considerable importance on the equity of the tax system:

- task (a) requires the Review to assess the extent to which the tax system can contribute to generating a fair distribution of income; and
- task (b)(i) requires the Review to determine whether the tax system can be made fairer in its role of redistributing income.

In particular, task (b)(i) requires the Review to consider:

- whether the income tax base should be broadened;
- the extent to which marginal rates should increase with levels of income, wealth and expenditure; and
- the best mix between different tax bases such as income, consumption, financial transactions and wealth.

This heavy emphasis on equity reflects concerns among some sections of the community that New Zealand's programme of economic reforms has resulted in greater income inequality. We believe the Review should:

- highlight the need to limit assistance to those in most need in view of the high and increasing economic costs associated with raising revenue and redistributing income; and
- identify the trade-offs that have to be made when designing equitable and efficient abatement regimes.

Increasing the progressivity of the tax system does very little to improve the equity with which income is distributed in New Zealand and reduces the overall efficiency of the tax system by increasing disincentives to work, save and invest, and attract and retain skilled labour, as well as administration and compliance costs.

Similarly, it is not clear that either the taxation of a much wider range of income from capital (eg via the introduction of a comprehensive capital gains tax), or the introduction of an annual tax on the value of certain assets, would improve the overall equity and efficiency of the tax system due to the problems associated with obtaining accurate estimates of asset values. From an economic perspective, a tax on assets is similar to an income tax. The former taxes the stock of assets whereas an income tax taxes the related income flow. Imposing a tax on assets that are built up from after-tax income is both inequitable and inefficient as it constitutes a further disincentive to save. There may be some scope for clarifying the current 'capital/revenue' boundary in order to reduce administrative and compliance costs, and erosion of the income tax base.

The proposal by the Alliance to replace GST with a financial transactions tax would certainly not improve either the equity or efficiency of the tax system. Rather than introduce new transactions taxes, the government should implement the policy of previous governments to phase out the remaining transactions taxes such as cheque and stamp duties as fiscal conditions permit.

4.1.1 Need to review the combined impact of the tax and benefit systems

We believe the government's decision to undertake the Review has been driven in part by concerns that the current tax system is inequitable. In particular, there are sections of the coalition government and the community who believe that:

- the programme of tax and economic reform to date has resulted in the 'rich getting richer and the poor getting poorer'; and
- high-income individuals and companies are paying little tax.

These popular misconceptions are driving not only the government's decision to establish the Review, but also its decisions to raise the top marginal tax rate and to increase government spending in an attempt to redistribute the benefits of economic reform to individuals on lower incomes. Such equity concerns also appear to be behind calls to replace the GST with an FTT, tax a wider range of capital gains, and introduce assets taxation.

For these reasons, we believe it is essential for the Review to:

- correcting these popular misconceptions; and
- refocus the government's attention on the need to improve the efficiency of the tax and benefit systems by limiting benefits to those in most need and reducing the economic costs arising from benefit abatement.

Information on how the distribution of income has been changing over time is available from the Statistics New Zealand study *New Zealand Now: Incomes* (SNZ 1999) which examined the distribution of real income in the years ending March 1982, 1986, 1991, and 1996.

Although that study found the distribution of income had become "substantially" more unequal between 1982 and 1996, it also indicated that:

- the distribution of income was broadly stable between 1982 and 1986 when most of the economic reforms were implemented, and between 1991 and 1996; and
- most of the shift towards a more unequal distribution of income occurred mainly over the period 1986 to 1991.

We believe much of that increase in the inequality of income over the period 1986 to 1991 can be attributed to the failure of the Labour government to:

- address the problem of growing welfare dependency (the number of welfare beneficiaries grew from about 100,000 in 1982 to over 300,000 in 1991, with more than 80 percent of that increase occurring between 1986 and 1991);
- reform the labour market, which accentuated the sharp rise in unemployment that occurred over that period. While unemployment is reported to have affected the whole distribution, that would not necessarily have been the case if the counterfactual were a more flexible labour market (Kerr (1999a).

The results of the Statistics New Zealand study and some other relevant studies also suggest that three popular perceptions about the impact of New Zealand's tax and benefit reforms on the distribution of income are doubtful:

- *'The rich are getting richer and the poor are getting poorer'*. The average real household equivalent disposable income of households in the top decile increased substantially between 1982 and 1996 and the income of households in the ninth decile increased by 3 percent but that for households in deciles 1 to 8 fell by between 2 percent and 11 percent. The income of households in deciles 1 and 2 declined by 3 percent and 5 percent respectively, that is by less than the average for middle-income households (deciles 3 to 8). Thus while households in the bottom quintile suffered a decline in income, middle-income households were affected to a greater extent. In particular, the study confirms there has been no rise in reported poverty since the reforms began. Between 1982 and 1996, there was no increase in the proportion of individuals or households with an income of less than 50 or 60 percent of median disposable income. Moreover, if the reform programme had continued, incomes would have been higher and fewer people would be dependent on welfare benefits. Although we do not have a long-term statistical series, it is probable that incomes have become more evenly distributed over the long run. Easton's analysis of individual tax data, for instance, suggests that income inequality reduced between 1953 and 1976 (Easton 1976).
- *'People on low incomes experienced a significant fall in their real disposable incomes as a result of the reduction in benefits in 1991'*. The study confirms that this was not the case. The average real income of those individuals in the bottom decile only fell by 1.75 percent, whereas the incomes of those in the second decile remained unchanged.
- *'Low-income households were badly affected by the introduction of GST in October 1996'*. As expected, the study confirms this was not the case. Low-income households were fully compensated for the effects of GST on prices through increases in benefits and the introduction of the family support and guaranteed minimum family income schemes.

The Review also needs to correct the popular misconception that high-income individuals pay little tax. As set out in Table 1 in section 3.1.6, households with market incomes in the two highest quintiles receive 76 percent of market incomes and pay 74 percent of direct taxes and 68 percent of all taxes.

The limited analysis of changes in the distribution of household income generally shows that it became more unequal between 1982 and 1996 primarily as a result of the reported growth in the income of high-income earners and a notable fall in the income of middle-income earners. Those who believe that any move to a more equal distribution of income is equitable and a move in the opposite direction is inequitable have deemed such changes inequitable. The question of what is an equitable distribution of income has, as far as we are aware, not been addressed. Moreover, a focus on the reported income distribution tends to obscure the reasons for low income, for instance factors such as marriage breakdown and, more generally, welfare dependency. Redistributive policies alone are certain to exacerbate such problems.

Need to limit assistance to those in most need

One of the key conclusions of the Review should be the need to limit government assistance to those in most need in view of the high and increasing costs of raising tax revenue and redistributing income.

As noted by the Ministry of Social Welfare (1999), the government's ability to improve the welfare of individuals is limited by a number of factors including:

- fiscal constraints: for example, improving family income through transfer payments is costly, as is the provision of additional health and education services. Such steps only deal with part of what is a complex pattern of pressures and dysfunction;

- societal and cultural constraints: for example, a government may want to improve parenting skills, but attempts to do so through legislative or coercive means are politically risky and of uncertain effectiveness; changing behaviours is difficult and takes time; and

- information constraints: the causes of family dysfunction are not well understood, and are likely to be multiple and complex, making effective interventions a matter of incremental and often experimental development.

In particular, there are deadweight costs associated with raising the necessary revenue needed to finance those benefits. There are additional deadweight costs associated with providing benefits to low-income individuals. The income effects of social welfare benefits reduce the incentive of beneficiaries to work, and can displace the assistance they otherwise may have received from other family members and charity.

As noted by the Ministry of Social Policy (1999):

> The total cost of income support (in real terms) rose significantly in the period from 1987-1994. Following a dip in 1995, it resumed its upward course, albeit at a lower rate. In the global economy, governments face growing pressure to maximise international competitiveness which includes controlling, and often reducing, public expenditure in order to avoid budget deficits. As the largest item on the expenditure side, social security is increasingly likely to attract attention. Thus the challenge facing the Government is to design social security programmes to help those who need it, while simultaneously reducing long-term costs.

It is important for the government to recognise that there are practical limits to the extent to which the tax and benefit systems can improve the welfare of individuals on low incomes. The costs of extending income redistribution beyond the provision of a social safety net are high and increasing due to the deadweight costs of taxation and the adverse effect that such assistance has on affected people, for instance by encouraging marriage breakdown and sole parenthood.

If the government is serious about helping those in greatest need, it must look beyond simple static analyses of the distribution of income in New Zealand and focus instead on broad policy initiatives directed at raising incomes, creating jobs, promoting individual responsibility, and promoting compassion for those facing hardship. Countries with high levels of economic freedom, involving open and competitive markets, typically have a more even distribution of income than government-dominated economies, as well as stronger growth.

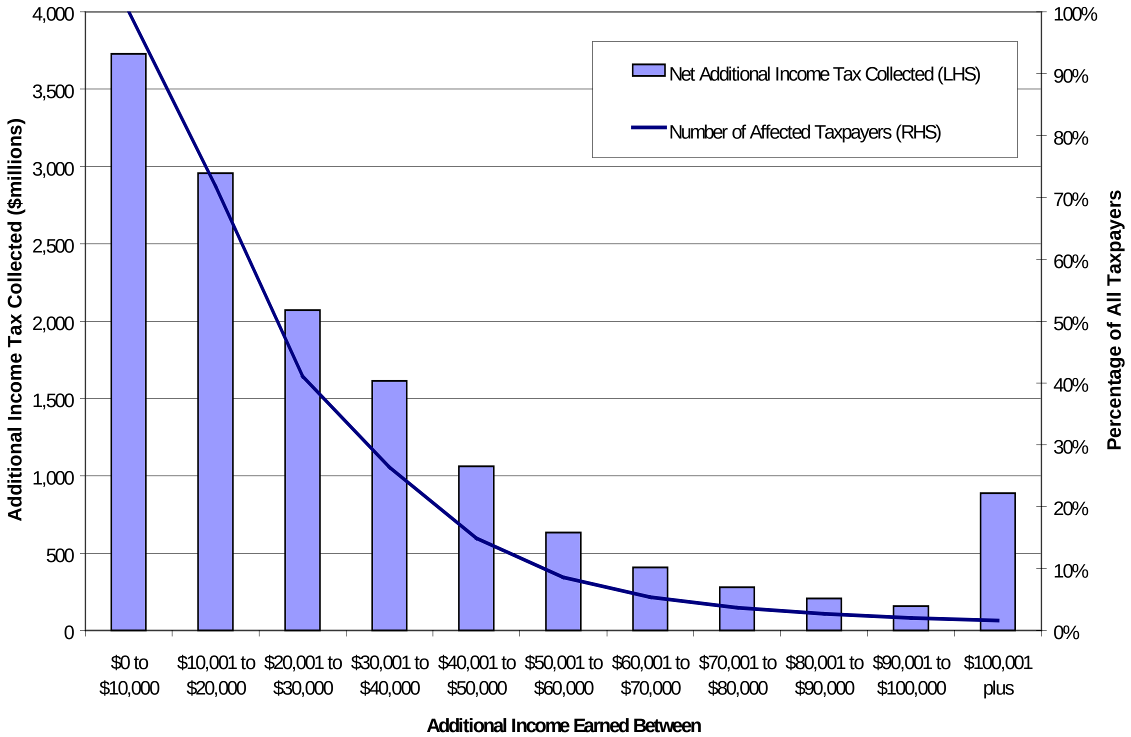
Need to identify the key trade-offs that have to be made when designing benefit abatement regimes and explore options for reform

Although it is desirable to target government assistance to those in greatest need, it is also important to consider the equity and efficiency implications of targeting benefits to those on low incomes. As noted in section 3.1.1, current benefit abatement regimes impose high effective marginal tax rates on low-income individuals. This is not only inequitable but it also reduces economic efficiency to some extent by reducing the incentive for those individuals to work and move off benefits.

As outlined below, complex trade-offs have to be made between the potential efficiency gains from reducing the provision of assistance to those who don't need it and the potential efficiency losses from abating benefits as income rises. It is important for the Review to highlight these key trade-offs and explore options for addressing this problem.

One approach to the problem is to reduce the bottom statutory marginal tax rate. This would reduce the effective marginal tax rates applying to low-income individuals and provide a greater incentive for them to move off benefits and re-enter full-time employment. The main problem with this approach, however, is that it would result in a significant reduction in tax revenue, most of it intra-marginal revenue. As noted in Figure 8, $3,730 million, or 27 percent of all personal income tax, is collected from the taxation of the first $10,000 of taxpayers' income.

Figure 8: Additional income tax collected from individuals by taxing their next $10,000 of income for the year ended March 1998



Source: IRD (1999b)

Attempts to make up that revenue shortfall by increasing statutory marginal tax rates for individuals on higher incomes would only serve to increase the progressivity of the tax system and increase the current disincentives for individuals on higher incomes to work, save and invest.

Another approach is to leave the bottom statutory marginal tax rate unchanged and lower the effective marginal tax rates facing low-income earners by abating the benefits over a wider range of income. Typically, this involves extension of benefits to those individuals who are earning low levels of income from either part- or full-time work, usually through the provision of a tax credit.

In general, tax credits are a more efficient means of providing benefits to low-income individuals in employment, since those credits eliminate the need for such individuals to pay tax and then receive that tax back in the form of a benefit (ie tax credits reduce the extent of 'churning' of income). However, problems arise once again when attempts are made to abate tax credits as income rises. Such abatement increases effective marginal tax rates facing individuals on low incomes, thereby reducing their incentive to work.

Those disincentives to work can be reduced to some extent by imposing time limits on assistance and making such assistance conditional on employment. As noted by the OECD (1996), employment-conditional tax credits or benefits tend to be more effective in those countries with wider earnings distributions and low tax rates. In such circumstances, such tax credits are able to increase the incomes of low-income families and restrict benefits to a small section of the population without creating significant disincentives to supply labour.

However, extending assistance to low-income individuals in part- or full-time employment also has the undesirable effects of:

- reducing the government's ability to assist those in most need (ie provide an adequate social safety net); and / or
- increasing the total cost of providing that assistance, to the extent that it is necessary to impose higher tax rates in order to raise the additional revenue required to fund an extension of assistance to those individuals.

A programme that abates benefits gradually over a wide income range leaves many people in receipt of welfare. This can reduce the government's ability to assist those in greatest need, increase the efficiency costs of providing that assistance, and leave beneficiaries with little hope of restoring their dignity and becoming more self-reliant.

An alternative approach proposed by Blinder and Rosen (1985) that warrants further analysis by the Review is to abate benefits over a narrower range of income. This has been the preferred approach in New Zealand tax policy in recent years.
Although this approach increases the effective marginal tax rates facing beneficiaries over that range of income, it reduces the number of individuals subject to higher rates of abatement, and the amount of time individuals spend on benefits and face those high abatement rates. It also means that modest increases in income can allow low-income individuals to 'hurdle' the income range over which the benefits are abated.

Such an approach focuses attention on the key issue - the relative magnitudes of the efficiency costs arising from high benefit abatement rates and the efficiency costs from extending benefits to a wider range of individuals. The efficiency costs arising from the imposition of higher effective marginal tax rates on either low-income individuals or all other taxpayers depend on a number of factors including:

- the extent to which effective marginal tax rates are increased;
- the number of individuals subject to those higher effective marginal tax rates;
- the amount of time those individuals are subject to those higher marginal tax rates; and
- the extent to which those higher effective marginal tax rates affect the decisions of those individuals to work, save and invest (ie the sensitivity of those decisions to increases in effective marginal tax rates).

This means that it is possible for the imposition of a higher effective marginal tax rate on a small number of people, for a limited amount of time, to produce lower total efficiency costs than the imposition of a permanent, marginally higher, effective tax rate on all middle- and upper-income taxpayers. This is the rationale underlying the current benefit abatement regimes.

Need to refocus the role of government, reduce taxes and provide direct assistance

A major problem with all of the approaches outlined above is that they implicitly assume that it is necessary to:

- retain tax rates at their current levels; and
- continue to provide benefits in their current form.

These assumptions in effect rule out consideration of what we believe to be the most effective and efficient approach to ensuring that assistance is limited to those individuals in greatest need. That approach involves:

- the government reducing its expenditure to a smaller proportion of GDP by restricting its activities to the provision of genuine public goods and a social safety net;
- implementing a lower and more uniform structure of statutory marginal tax rates; and
- providing a greater proportion of assistance to the poor in a direct form (eg via targeted cash assistance, or possibly means-tested vouchers for education, health care and other essential services).

At the moment, statutory tax rates, and consequently benefit abatement rates, are much higher than they need to be due to the government's involvement in activities that extend well beyond its appropriate role. This has:

- crowded out private sector initiatives, including personal and community initiatives;
- diverted resources from more productive activities in the economy;
- placed a major burden on businesses and individuals who must pay the high rates of tax required to fund these additional activities, thereby reducing their incentives to work, save and invest; and
- reduced the quality of the government's core services, and the efficiency with which those services are provided.

As noted by Cox (1998), there is also scope to reduce some of the benefit rates in New Zealand:

> Although unemployment benefit rates are similar in relation to earnings in both Australia and New Zealand, invalids benefit rates are, if the accommodation supplement is taken into account, frequently about 10 to 15 percent higher (or more) in New Zealand than in Australia. Benefits for sole parents in Australia and New Zealand are higher than in Great Britain or the United States (Whiteford, 1997, p 51). It is questionable, in my view, whether the New Zealand benefits system strikes the right balance between avoiding hardship, on the one hand, and avoiding he adverse consequences of benefits on the other. The extremely generous benefits paid to persons receiving accident compensation from ACC raise similar questions. A reduction in benefit levels could have the valuable further effect of aligning invalids and sickness benefit rates, as is the Australian practice, with the unemployment benefit rate. This, in turn, would reduce the incentive for some unemployed beneficiaries to present themselves as invalid or sick, and hence move out of the labour force, to qualify for more prestigious and less onerous benefit. A policy of encouraging a reduction in the supply of labour can only be damaging to New Zealand's long-term economic interests. I am not suggesting that unemployment benefit rates need to be reduced further in New Zealand.

In particular, consideration needs to be given to reducing the current accommodation supplement (eg through greater private provision, and remodelling the scheme along the lines of the Australian system).

Other potential approaches to reducing benefit dependency include:

- revised eligibility conditions for the invalids and sickness benefits;
- time limits for benefits; and
- requiring beneficiaries to meet additional job search, education, training and work requirements.

While acknowledging that there are no easy answers on the design of abatement regimes, our preferred approach is summarised below:

- A relatively high effective marginal tax rate faced by a small number of low-income people may impose lower overall deadweight costs than a marginally higher effective marginal tax rate on all middle- and upper-income taxpayers. On the other hand, excessively high effective marginal tax rates for beneficiaries can be expected to be very costly.

- People should have reasonable expectations of passing beyond the income range over which high effective marginal tax rates apply. Thus the application of such rates over the broad range of income earned by many people is particularly problematic. The proposed 100 percent effective marginal tax rate on private savings under the retirement savings scheme (RRS) was an example. High spikes that abate assistance quickly and apply to few people may be preferable.

- Government spending should be reduced. This would allow the income tax scale to be lowered and made more uniform, and would provide greater scope to abate assistance without requiring unduly high abatement rates.

- Benefit and other assistance levels should be no higher than necessary to avoid hardship. This would provide greater incentives for people to obtain work and allow assistance to be abated at a lower rate than otherwise.

- Abatement should start with the first dollar of other income. In the case of benefits, the benefit level effectively constitutes the safety net. Any additional income indicates an income level in excess of the minimum level provided by the government.

- Effective marginal tax rates should generally be no higher than, say, 70 percent. They should possibly be lower where they are most likely to affect long-term decisions or apply to wide bands of income that affect many people.
- With a statutory tax rate of, say, 20 percent, the abatement rate would be no higher than 50 percent. This takes account of income tax rates alone and ignores the effect of taxes on spending.

4.1.2 Why not make tax rates more progressive?

Underlying the government's recent decision to increase the top marginal tax rate from 33 to 39 percent appears to be the view that it increased the equity with which income is distributed in New Zealand and had little effect on the overall efficiency of the tax system.

Unfortunately, this is not the case. Progressive rates of income tax are inefficient and the grounds for redistributing income from higher-income individuals to those on low incomes, beyond the avoidance of poverty, are weak. Increasing the progressivity of the tax system would not significantly improve the equity with which income is distributed in New Zealand. Much of the redistribution of income effected by the current graduated personal tax scale does little to improve the well being of low-income individuals. For example, as noted above, a large proportion of the income raised from imposing higher marginal rates of tax on middle- and high-income households is given back to those households in the form of subsidised services. This does little to improve equity with which income is distributed. Similarly, since the incomes of most individuals increase over their working lives, progressive tax rates tend to redistribute income over people's lifetimes. Once again, such redistribution is not necessary and does little to improve equity.

Increasing the progressivity of the tax system also reduces the overall efficiency of the tax system by increasing the deadweight costs of raising tax revenue. It does this by increasing disincentives to work, save and invest and reduces New Zealand's ability to attract and retain skilled labour.

It also increases the administration and compliance costs associated with raising revenue by reducing the effectiveness of withholding taxes. The greater the number of graduated marginal tax rates, the more difficult it is to collect tax revenue using single-rate withholding taxes, since there will always be individuals with marginal tax rates that are either above or below the rate of withholding tax. This means that it is either necessary to introduce multi-rate withholding tax regimes, or require taxpayers to submit returns to obtain a refund for tax over-withheld or to determine the amount of additional tax they have to pay. Either way, the administrative and compliance costs associated with collecting tax revenue under such a progressive tax system are much higher than they would be if marginal tax rates were more uniform.

It is important to note that the current tax system was designed around the assumption that income tax rates would be relatively low and uniform. This was generally the case up until around 1996. Most taxpayers were subject to the middle marginal tax rate of 28 percent, or the top rate of 33 percent. This enabled the efficient collection of tax on the wages, fringe benefits, interest and dividend income of a large number of individuals using single-rate withholding taxes.

However, changes to the tax scale in 1996, 1998 and 2000 have produced a scale of personal tax rates that are much higher and more uneven than was anticipated when the major features of the current tax system were designed. These changes have reduced the efficiency of the single-rate withholding tax regimes as a means of raising revenue and have increased the scope for taxpayers to evade tax through non-declaration of income.

When the government decided to raise the top marginal tax rate to 39 percent, it was forced to make numerous amendments to current withholding tax regimes in an effort to realign withholding tax rates and reduce the scope for high-income individuals to avoid paying more tax. In particular, it had to:

- increase the rate of specified superannuation contribution withholding tax (SSCWT) from 33 percent to 39 percent by requiring employers to:
  - voluntarily apply a 39 percent rate to all employees (only really an option where all employees earn more than $60,000); or
  - apply an additional superannuation fund withdrawal tax of 5 percent to amounts withdrawn by an employee, other than on termination of employment or for hardship reasons;

- introduce a multi-tier fringe benefit tax regime, which applies FBT at a rate of:
  - 27 percent for individuals with incomes up to $38,000 (ie those on marginal tax rates of 21 percent);
  - 49 percent for individuals on incomes from $38,000 to $60,000 (ie those on marginal tax rates of 33 percent); and
  - 64 percent for individuals on incomes over $60,000 (ie those on marginal tax rates of 39 percent);
- require companies to adopt a minimum withholding rate of 33 percent; and
- increase the rate of tax applying to the beneficiary income of minors from the marginal tax rate of the minor, which could have been as low as 19.5 percent, to 33 percent.

While the legislative amendments outlined above may have reduced the ability of high-income taxpayers to avoid the top marginal tax rate to some extent, they have also increased the administrative and compliance costs associated with raising tax revenue.

In addition to reducing the efficiency of New Zealand's withholding tax regimes, the trend towards a more progressive 'graduated' scale of tax rates has also increased the scope for income splitting. The gap between the middle and top effective marginal tax rates has increased from 5 percentage points in 1996 (the difference between the 28 and 33 percent rates) to 18 percentage points (the difference between the 21 and 39 percent rates).

Increasing the top marginal tax rate to 39 percent has also provided a significant incentive for high-income individuals to devote more resources to tax planning. Indeed, it has increased the value of tax concessions provided to certain activities, further reducing the overall quality of investment. Concessionally taxed activities are now a much more profitable form of investment than they were in the past.

Rather than increase the progressivity of tax rates, the preferable approach to improving the extent to which the tax and benefit systems are improving the equity with which income is distributed in New Zealand is to:

- reduce government expenditure on non-core services and improve the quality of core services;

- reduce the provision of benefits to middle- and high-income earners; and
- introduce lower and more uniform rates of personal tax to reduce the disincentives to work, save and invest and improve New Zealand's ability to attract and retain skilled labour.

4.1.3 Why not broaden the income tax base to include a wider range of income from capital?

New Zealand already taxes a wide range of income from capital including:

- gains realised on the sale of property acquired for sale, such as shares held on 'revenue account';
- gains in the value of financial arrangements, which are taxed as they accrue; and
- gains in the value of foreign investments in controlled foreign companies and foreign investment funds, which are taxed as they accrue.

However, unlike most OECD countries, New Zealand does not comprehensively tax capital gains made by individuals on the sale of property. Where property is acquired for investment purposes and held on 'capital account', any gains realised on the sale of that property are not subject to tax. For example, individuals who acquire shares for 'passive' investment purposes are not subject to tax on any gains realised on the sale of those shares.

This has led to a recent recommendation by the OECD (2000a) that New Zealand should seek to improve the efficiency and equity of its tax system by extending the income tax base to include a more comprehensive range of capital gains and the imputed rental income from owner-occupied housing:

> There is no need for major tax reform. However, several second-order issues should be addressed to reap the full benefits of an otherwise well-functioning system. The most important improvement would be a broadening of the income tax base by including capital gains in a more comprehensive way as well as introducing a tax on imputed rental income of owner-occupied housing beyond the local property tax. These two steps would not only reduce horizontal inequities, and hence tax-shifting incentives, but also contribute to a better allocation of private saving, which

is currently biased strongly toward housing, resulting in unbalanced household portfolios.

There are two aspects of this recommendation that are of concern to the NZBR.

First, although we agree that there is limited scope for further *structural* reform of the tax system, there is still an urgent need to reduce total spending and taxation in New Zealand in order to reduce disincentives to work, save and invest, and to help New Zealand attract and retain skilled labour.

Second, the recommendation fails to recognise the considerable practical problems associated with the comprehensive taxation of capital gains. In theory, if the income tax system is to be neutral across all investments, it needs to tax all capital gains as they accrue to the taxpayer. In practice, however, this is not feasible due to the lack of accurate information on the manner in which asset values change over time. This is the reason why most capital gains are only taxed when they are realised, and also explains why some forms of capital gains are excluded from the tax base. Similar measurement problems are raised by the proposals to tax imputed rental income.

There is no guarantee that the introduction of a comprehensive capital gains tax on a realisations basis would improve the overall efficiency of the income tax regime. Rather than improve the efficiency of the tax system, the taxation of capital gains on a realisation basis can actually reduce its efficiency by:

- locking taxpayers into the ownership of assets; and
- providing opportunities for taxpayers to reduce the amount of tax that would otherwise be payable by realising capital losses.

There are also problems in distinguishing real from nominal capital gains, and in providing neutral treatment of capital losses.

For these reasons, the NZBR does not support the introduction of a comprehensive capital gains tax. The trend in some other countries has been to reduce taxation of capital gains. A preferred approach is to lower all income taxes, especially marginal rates, so that the distortions arising from a lack of comprehensive treatment are reduced. In the absence of a tax on the imputed rental value of owner-occupied housing, this is the best means of reducing distortions in favour of housing which is a particularly tax-favoured investment.

However, we do recognise that it may be necessary to clarify the current boundary between taxable and non-taxable capital gains, particularly the current distinction between 'passive' and 'active' shareholdings, in order to reduce administration and compliance costs as well as potential erosion of the current income tax base.

4.1.4 Why not collect more revenue through the taxation of assets?

It is sometimes suggested that New Zealand's tax base needs to be brought more into line with those of other OECD countries through the introduction of taxes on assets, particularly an annual wealth tax.

It is important to note, however, that after adjusting for social security contributions, the composition of New Zealand's tax base is broadly similar to the OECD average. In particular, as indicated in Table 4, New Zealand, like most other OECD nations, collects only a relatively small proportion of its total tax revenue from taxes on property. Although several Scandinavian and European countries impose taxes on net wealth, most of these countries raise less than 1 percent of the total tax revenue from this source. The exceptions are Norway which raises 1.43 percent, Iceland which raises 2.19 percent, Switzerland which raises 3.83 percent and Luxembourg which raises 5.37 percent of its total tax revenue from net wealth taxes.

This raises the question as to whether the equity and efficiency of the tax system could be improved by collecting a greater proportion of revenue via, say, an annual wealth tax.

Unlike a capital gains tax, an annual wealth tax would tax the underlying value of individuals' assets even if the value of those assets did not change over time. Where the value of those assets increases over time, however, an annual wealth tax would tax not only the underlying value of those assets but also the capital gain in the value of those assets over the year. That is, an annual wealth tax would tax capital gains as they accrue to the owners of those assets.

Table 4: Estimated property tax revenue (% of total tax revenue 1997)

	Recurrent taxes			Transactions taxes		Non-recurrent taxes	Total tax on property
	Net wealth	Rates and land tax	Other	Estate, gift & inheritance	Financial & capital		
Australia	0.00	4.66	0.00	0.00	4.18	0.00	8.78
Austria	0.03	0.60	0.00	0.11	0.61	0.00	1.34
Belgium							2.83
Canada							
Czech Republic	0.00	0.60	0.00	0.08	0.69	0.00	1.37
Denmark	0.00	2.03	0.00	0.40	0.94	0.00	3.35
Finland	0.10	0.89	0.00	0.48	0.86	0.00	2.33
France	0.53	2.85	0.00	1.07	1.04	0.00	5.50
Germany	0.63	1.13	0.00	0.30	0.69	0.00	2.76
Greece							
Hungary	0.00	0.40	0.00	0.12	0.00	1.04	1.56
Iceland	2.19	3.44	0.00	0.30	2.25	0.00	8.18
Ireland	0.00	2.94	0.00	0.59	2.35	0.00	5.29
Italy	0.77	18.63	0.00	0.16	2.34	0.00	5.14
Japan							
Korea							
Luxembourg	5.37	0.27	0.00	0.35	1.87	0.00	7.86
Mexico							
Netherlands	0.55	1.83	0.00	0.68	1.57	0.00	4.60
New Zealand	**0.00**	**5.00**	**0.00**	**0.00**	**0.56**	**0.00**	**5.56**
Norway	1.43	0.00	0.00	0.22	0.43	0.00	2.08
Poland	0.00	2.91	0.00	0.05	0.00	0.00	2.96
Portugal	0.00	1.11	0.00	0.23	1.08	0.00	2.43
Spain	0.43	1.94	0.03	0.55	2.34	0.40	5.70
Sweden	0.47	2.98	0.00	0.19	0.28	0.00	3.93
Switzerland	3.83	0.47	0.00	0.86	2.19	0.00	7.42
Turkey	0.00	0.00	0.00	0.04	1.75	0.00	1.79
United Kingdom	0.00	9.12	0.00	0.58	1.12	0.00	10.81
United States							

Source: OECD (1998)

As a result, annual wealth taxes are just as difficult to design and implement as are accrual capital gains tax regimes. In practice, it is extremely difficult to obtain accurate values for many classes of assets and liabilities. In view of these valuation problems:

- annual wealth taxes are often restricted to a limited range of relatively homogeneous assets that are traded frequently in large volumes (as is the case with accrued capital gains taxes); and
- other assets taxes are applied only on a 'realisation' basis when assets are sold or transferred to another individual.

This means that assets taxes have the potential to distort patterns of investment between those assets subject to the annual wealth tax and those that are not. In addition, assets taxes can also distort patterns of investment between those assets that are subject to the tax due to inaccuracies in the measurement of the values of those assets.

We do not believe that the introduction of greater asset taxation in New Zealand would improve either the equity of the tax system or its efficiency.

Very little is known about the current distribution of wealth in New Zealand, and the form in which that wealth is held. As a result, there is no *a priori* reason to expect that the introduction of assets taxation on a limited range of assets would improve the overall equity of the tax system. A double tax on both the flow of income and the stock (assets) would be inequitable.

In addition, there is no reason to expect that increased asset taxation would improve the overall efficiency of the tax system. Rather, it would only increase current disincentives to save and invest by increasing the effective marginal tax rates applying to income from capital, and further reduce the quality of investment by increasing disparities in effective marginal tax rates across different investments. There would be a strong incentive for people with significant assets to migrate to countries that do not impose an assets tax, such as Australia.

New Zealand's two broad tax bases - income and consumption spending - are more than capable of generating sufficient revenue to fund expenditure on core government functions in the foreseeable future.

4.1.5 Why not replace the GST regime with a financial transactions tax?

In October 1993, the Alliance released three papers that proposed that GST be phased out and replaced by a financial transactions tax (FTT). The proposed FTT would be imposed at a flat rate on bank withdrawals.

This proposal appears to have been motivated by the view that the GST regime is regressive and the desire to:

- increase the progressivity and improve the perceived equity of the tax system;
- tax the financial system;
- discourage speculation; and
- advance neutrality.

The NZBR's views on such a financial transactions tax are outlined in a study *Would a Financial Transactions Tax be more Efficient and Equitable than the Goods and Services Tax?* (NZBR 1996), which has been made available to the Review.

In brief, we do not consider that replacing GST with a FTT would improve either the equity or efficiency of the tax system.

In relation to GST, the proposed FTT would be a relatively inefficient source of revenue since it would:

- discourage saving and investment, unlike a GST which applies only to consumption;
- distort patterns of investment by imposing different effective marginal tax rates on different activities. For example, it would impose higher effective rates of tax on the production, distribution and consumption of perishable basic foods such as bread, milk and vegetables, which have to be purchased frequently;
- reduce the efficiency of financial markets by:
  - distorting the choice of financial instruments and reducing the efficiency of financial markets by imposing different rates of tax on financial instruments that have the same economic effect. In particular, it would impose very high rates of tax on the interest earned from short-term bank deposits, thereby discouraging the

use of bank accounts as investments and encouraging individuals and firms to hold higher cash balances;

- reducing liquidity; and
- increasing transactions costs and hence the cost of capital;

- discourage exports. Although exports are exempt from GST, they would be subject to the proposed FTT;
- encourage imports of certain goods. Although most imported goods are subject to GST, some of those goods would escape FTT. For example, imports of goods financed by export receipts or drawing on overseas credit would not be subject to FTT;
- be easier to avoid than a GST. While all taxes provide both incentives and opportunities for tax evasion and avoidance, a GST has a number of in-built features that limit the extent of avoidance, unlike the proposed FTT; and
- lack the transparency of a GST.

4.1.6. Need to phase out remaining transactions taxes

Rather than introduce new transactions taxes, the government should implement the decisions of previous governments to phase out remaining cheque and stamp duties as fiscal conditions permit.

4.2 HOW CAN WE IMPROVE THE EFFICIENCY OF THE TAX SYSTEM?

4.2.1 How can we reduce the disincentive to save and invest?

Why not introduce a 'Nordic' dual income tax?

If income from capital is highly mobile, why not reduce rates of tax on that income, while continuing to subject income from labour to higher progressive rates of tax?

Such a 'dual' income tax regime was introduced in Norway in 1992 and similar systems have been introduced in Denmark, Sweden and Finland. The Netherlands is also currently considering the implementation of such an approach (see Van den Noord (2000) for a discussion of Norway's dual income tax system).

In Norway, the dual income tax system involves imposing:

- a 28 percent flat rate of tax on the total net income of individuals (including realised capital gains and imputed rental income from owner-occupied housing) at the company tax rate of 28 percent;
- an additional surtax of 13.5 percent on income that is not eligible for deductions (labour, self employed labour, and pension income);
- an additional social security contribution levy of:
  - 7.8 percent on labour income;
  - 10.7 percent on self-employed labour income; and
  - 3 percent on pension income.

This system produces:

- a flat rate of tax of 28 percent on income from capital; and
- the following top marginal tax rates on labour income:
  - 49.3 percent for a salaried worker;
  - 52.2 percent for a self-employed worker; and
  - 44.5 percent for a pensioner.

At first sight, a dual income tax system appears to have a number of advantages. In particular, it appears to provide a means of:

- encouraging savings and investment by lowing the rate of tax applying to income from capital in the hands of individuals;
- reducing the extent to which the tax system:
  - distorts patterns of investment, since it applies a uniform flat rate of tax to all forms of income from capital; and
  - encourages individuals to invest directly rather than via intermediaries, since the income from capital derived by a company is taxed at the same rate as the income from capital of an individual investor.

On closer inspection, however, a dual income tax system has a number of major problems.

A dual system encourages tax planning and distorts individuals' decisions regarding the manner of organising their business activities.

For example, a dual income tax system provides an incentive for individuals to recharacterise their labour income as income from capital. This is particularly easy for individuals who are either self-employed or who own and operate small businesses. Such individuals are able to reduce their taxable income by:

- paying themselves relatively low wages (ie understating the value of the labour services they supply to the business); and
- deriving most of their income in the form of distributions of profit which are taxed at the lower rate.

Norway seeks to deal with this problem through the use of a 'split model' which divides the business income of the self-employed and individuals who own and run small businesses (ie 'active' shareholders) into:

- ordinary income (ie gross business income less deductions for interest expense and depreciation) which is taxed at the flat rate of 28 percent; and
- imputed personal income, which is taxed at more progressive rates.

Imputed personal income is estimated by calculating total business income and subtracting:

- imputed capital income, which is calculated at an assumed rate of return set by parliament of 10 percent (the average government bond rate of 5 percent plus a risk premium of 5 percent); and
- an allowance for capital income arising from goodwill that is not quantified in the balance sheet, which is calculated at a rate of 20 percent of salaries paid to employees.

At best, such a 'split model' produces a rough estimate of the value of the labour services supplied by the individual to the business. The accuracy of that estimate is dependent on the accuracy of the assumptions it makes about:

- the rate of return being earned on the physical assets used by the firm - such a presumed rate of return will not be accurate for businesses that are in loss, just starting up, or in the process of restructuring. In such cases, the value of labour services provided may be understated; and

- the assumed value and rate of return on goodwill not recorded in the accounts.

Even in the presence of such a 'split model', there is still considerable scope and incentive for individuals to transform their labour income into income from capital.

For example, under the 'split model' individuals can reduce their tax liability by overvaluing their assets in order to derive a greater proportion of their income in the form of income from capital. The scope for such tax avoidance is greater for those businesses that use large quantities of capital than it is for businesses comprising groups of professionals providing labour services.

The 'split model' also provides an incentive for the owners of small businesses to dilute their shareholding to escape the provisions of the split model. The 'split model' only applies to 'active' shareholders, that is, individuals who own more than two thirds of the shares in the business or who are entitled to more than two thirds of the dividend income it distributes. As a result, 'active' shareholders can escape the additional surtaxes on 'labour' income by issuing shares to family members to dilute their shareholding below that threshold to become 'passive' shareholders.

In order to address this problem, Norway introduced 'identification' rules which define the types of individuals who may or may not be considered to be 'passive' shareholders. In particular, it restricts 'active' shareholders from avoiding additional tax on their labour income by issuing shares to their relatives.

A dual income tax system also provides incentives for individuals who derive most of their income from the provision of professional services (eg lawyers, accountants, dentists etc) to incorporate and qualify as 'passive' company owners in order to reduce their tax liabilities.

We conclude that a dual income tax system is an unattractive option for New Zealand. Its chief merit of reducing taxation on capital income and the high deadweight costs associated with such taxation is better pursued by reducing the top personal and company tax rates. Such an approach is more feasible in New Zealand than in Nordic countries which still have very high levels of government spending.

Why not just lower the rate of company tax?

Another suggestion which has some features that are similar to the Nordic dual tax system is that the rate of company tax be reduced to a level well below the top personal rate of tax, say, 15 percent. This idea is motivated by the laudable desire to reduce the level of taxation on capital income with its associated high deadweight losses and encourage investment, innovation and foreign investment in New Zealand.

With imputation, however, there is effectively no such thing as an entirely separate company tax, at least for domestic shareholders. The thrust of recent tax reform has been to 'look through' organisations such as companies and similar entities and, where feasible, attribute tax to the ultimate owners or investors. In this way double taxation of income is avoided and investors are more likely to be taxed at their appropriate marginal rates. In the context of company taxation, therefore, the concern to reduce taxation of capital income should be focused on the ultimate shareholders.

Delinking the company tax rate from the personal tax rates of investors creates a number of problems. If the company tax rate is lower than that applicable to investors, companies have an incentive to retain their profits and reinvest them at the lower rate of tax. The proposal would thus favour the growth and development of established firms that are able to fund their investment proposals from retained earnings relative to new enterprises and those that require new equity capital to expand. Much innovation arises from new firms.

While company tax is largely a tax on the return to capital, shareholders in small businesses can elect to take their income in the form of a return to capital or as labour income. Thus both the Nordic dual tax system and a company rate that is below relevant personal tax rates create incentives to treat labour income as capital income and thereby benefit from a lower rate of tax. More generally, a wider gap between the rates of company tax and personal tax would exacerbate the range of effective marginal tax rates and add to the complexity of the tax system.

Because of imputation, a reduction in just the company tax rate would mean that the effective marginal tax rate on new equity-financed investment would not be reduced for domestic investors who presently face a tax rate at least equal to the present company tax rate. This includes all taxpayers on the 33 or 39 percent personal rates, or who are subject to higher rates because of the abatement of government assistance, and superannuation funds and other trusts (unless their tax rate were also reduced). The vast majority of resident equity investors could be expected to be on a 33 percent or higher effective marginal tax rate. Low to modest income earners are unlikely to be marginal investors.

If the tax rate payable by superannuation funds were also reduced, then a significant proportion of domestic investors would face a lower effective marginal tax rate on investment financed from new equity.

As far as foreign equity investors are concerned, the effective marginal tax rate they face includes company tax, non-resident withholding tax and the FITC. A reduction in the rate of company tax would initially increase the return to foreign investors. It is reasonable to assume that foreign investors are marginal investors especially in the larger companies listed on the New Zealand Stock Exchange. Most foreign portfolio investment seems to be concentrated in such companies.

A reduction in the company tax rate could therefore be expected to raise equity prices and thereby lower the cost of capital through its impact on foreign equity investors. This would also encourage new equity investment by New Zealand firms.

The key question is whether this is the most desirable strategy for reducing the tax burden on capital. It implies that the government should seek to reduce the cost of capital by lowering the tax payable by companies but not other businesses. It also implies that returns on domestic capital should be taxed less heavily than returns from labour. A reduction in the rate of company tax to 15 percent would cost about $2 billion a year (5 percent of government revenue) assuming no change in behaviour. Much of the revenue lost would arise from intramarginal tax cuts. Additional revenue would need to be raised by increasing other tax rates such as personal tax, with little net benefit in terms of efficiency.

Given that tax on foreign equity investment appears to be the main influence on the cost of capital, a more direct strategy would be to address the issue via the international tax regime. A reduction in the cost of capital could be achieved at a lower revenue cost by increasing the FITC rather than by reducing the rate of company tax in isolation from other income tax rates. We believe that the preferable strategy is to adopt lower and more uniform rates of tax on the investment of residents and to increase the FITC. The high compliance and administration costs created by divergent rates of personal and company tax should be avoided. The company tax rate should generally be aligned with the top personal tax rate and both rates should be reduced.

Why not introduce a cash flow tax?

There is substantial support in the literature for taxing business activities on a cash flow basis. A cash flow tax is a direct expenditure tax. Its economic effects are broadly similar to those of GST. However, being a direct tax, it is possible to apply a progressive rate scale. Furthermore, unlike GST, offshore activities can be included within a cash flow tax base.

Cash flow taxes are often advocated because capital expenditure is deducted immediately. For this reason, cash flow taxes, like GST and unlike an income tax, do not discourage investment and saving. Thus the normal return on investment is exempt from tax but excess returns or rents are taxed.

Many of the difficulties of applying an income tax arise from the taxation of income from capital. Ideally, changes in the value of assets and liabilities should be taken into account as they accrue. This is infeasible and compromises have to be made. They lead to many of the more difficult problems that arise in taxing income.

At first sight, a cash flow tax offers an attractive solution because assets and liabilities are treated on a cash flow basis which is simpler. Cash flow taxes, however, also entail serious problems. Because the tax base is narrower than that of an income tax, a higher rate of tax is required to raise the same level of revenue. Moreover, during the transition phase, the government would face a substantial loss of revenue as capital spending is immediately expensed for tax purposes. In addition, a switch from an income tax to an expenditure tax imposes a large tax on existing wealth. The transition from an income tax to a cash flow tax is complex and is little discussed in the literature. Finally, there is uncertainty about how cash flow taxes might be viewed by New Zealand's trading partners given that double taxation agreements focus on income taxes.

A cash flow tax was examined in the mid-1980s when the basic structure of the tax system was reviewed. It was judged to be less desirable than GST which has many of the same desirable properties. The tax system was subsequently developed around an income tax and a GST. It would be a major undertaking to change to a cash flow tax. The merits of a cash flow tax were re-examined recently and a similar conclusion, which we share, was reached. We do not think that a cash flow tax warrants detailed investigation by the Review. A better strategy to encourage saving and investment is to reduce government spending, lower the rates of income tax and thereby collect a higher proportion of total tax via GST.

Why not introduce special tax concessions to encourage saving and investment?

Another common approach used with the aim of encouraging saving, investment and economic growth is the provision of tax concessions to certain 'desirable' activities such as saving for retirement, investment in new plant and equipment, film production, mineral exploration, and research and development.

Typically, those concessions are provided by:

- excluding certain forms of income from the tax base, or taxing certain forms of income at reduced statutory rates of tax (eg Australia and the United States both tax capital gains at a lower rate than other forms of income from capital); or
- increasing the amount of expenditure that is deductible for taxation purposes (eg Australia has sought to encourage investment in research and development through the provision of deductions in excess of the total cost of such investments); or
- advancing the recognition of expenditure (eg New Zealand still enables taxpayers to bring forward the recognition of expenditure on new plant and equipment by applying a 20 percent loading to the actual economic rates of depreciation); or
- deferring the recognition of income (eg Australia seeks to stimulate private saving by enabling taxpayers to contribute to superannuation saving schemes out of pre-tax income which is then subject to a reduced rate of tax when it is invested in the scheme).

Unfortunately, rather than increase overall levels of saving and investment, such concessions tend to reduce the quality of investment decisions. That is, they tend to divert investment from activities that would be more beneficial to the nation as a whole. Tax concessions also:

- erode the tax base, placing a greater tax burden on activities that are not eligible for such concessions;
- provide an open-ended level of assistance which is difficult to monitor and control;
- permit assisted providers to increase their costs, thereby capturing at least part of the concession; and
- encourage other taxpayers to lobby for similar concessional treatment.

In many cases, the benefits provided by tax concessions also end up in the hands of individuals other than the intended recipients.

Given a valid concern that income tax is unduly discouraging saving and investment, the first step should be to reduce government spending and high effective marginal rates of income tax. In this way a greater proportion of income would be raised via the GST regime which does not tax saving. The OECD (2000a) has noted that:

> It might be argued that tax policy could also play a role in raising the low level of private savings in New Zealand. However, targeted tax incentives are likely to result primarily in shifting savings into lower taxed portfolios and any possible impact on private savings will probably be more than offset by reduced government savings as tax revenues decline. A more promising direction would be a revenue-neutral change in the tax mix toward more consumption tax and less income tax, but even though such a move could potentially spur private savings, most available empirical evidence suggests the effect would likely be moderate.

There is limited scope to increase GST without exacerbating problems of avoidance and evasion. The idea of implementing such an increase could also reflect a failure to constrain government spending, which was the case when GST was raised from 10 to 12.5 percent in 1989. Our preference would be to change the tax mix further towards GST not by increasing the rate but in the context of a lower government spending ratio and reductions in income tax.

Need to remove existing tax concessions and lower tax rates

Rather than introduce additional tax concessions to stimulate saving and investment, the preferable approach is to:

- remove existing tax concessions, including accelerated depreciation allowances, research and development concessions, and the concessions currently extended to the film, forestry and mining industries. An issue here is the determination of a neutral basis of tax treatment for these activities and industries; and
- lower tax rates.

Such an approach has the potential not only to reduce the overall tax disincentive to save and invest, but also to improve the quality of patterns of investment.

Although we do not believe the government should seek to encourage saving and investment by providing special concessions to particular forms of investment, we do support strongly the need to reduce current tax disincentives to save for retirement. New Zealand Superannuation, which is provided on universal basis, is the biggest single impediment to saving for retirement. Relative to many other benefits, it provides a generous level of income for most people in retirement and as a result additional saving for retirement by most people of working age on low to average incomes is unlikely to be a priority.

New Zealand has made considerable progress over the last two decades towards the development of a less distorting environment for investment. Most of the alternative forms in which individuals can invest their savings are taxed in the same manner. As with investments in banks and other financial institutions, contributions to superannuation schemes must be made out of after-tax income, the income derived by the fund is taxed, and distributions of that income are exempt from tax (ie all are subject to a 'TTE' tax treatment).

In addition, as noted in section 3.2.1, New Zealand also has made considerable progress towards reducing both the disincentive to save and invest by reducing tax rates. In particular, the decision to reduce rates of tax on the New Zealand sourced income of foreign investors has helped New Zealand to reduce the effective marginal tax rates applying to investment and the domestic cost of capital in New Zealand.

However, these reforms mean that the New Zealand tax system now tends to impose a higher effective rate of tax on saving for a given level of personal tax than other tax systems. This highlights the importance of reducing personal tax rates in order to reduce the current disincentive to save. In this regard, the government's recent decision to raise the top personal tax rate is at odds with its desire to encourage saving.

It is commonly objected that reducing the top personal tax rate benefits better-off people. This is inevitable because better-off people pay more tax. However, a broader perspective needs to be taken. Better-off people will continue to pay more tax even with a more proportional tax system. As noted, the equity case for a progressive tax is weak. Experience suggests that the share of tax paid by higher-income taxpayers often increases with cuts to high tax rates, as incentives to earn income are increased and incentives to engage in tax planning are reduced. Moreover, the category of better-off people is not static. Many people who would not immediately benefit from a cut to the top tax rate can hope to do so over time. Perhaps most importantly, the reductions in deadweight losses resulting from cuts to high tax rates, as well as the efficiency gains from a flatter tax scale, help stimulate economic growth and improve the prospects of people on low incomes, which should be the priority goal.

The need to relax the tax treatment of losses

Under the present tax rules companies (other than qualifying companies) are unable to obtain a cash refund when they incur a loss. Instead they are permitted to carry the loss forward and offset it against future profits provided that there is at least a minimum level of common shareholding at the time of the loss and offset.

In the 1991 budget, the government moved to restrict the ability of companies to carry-forward losses to be offset against future profits and to offset losses against current profits of related companies. The key measure involved an increase in the ownership continuity rule from 40 to 66 percent. It was also decided to introduce the qualifying company regime, which allows certain tightly held companies to flow losses through to individual shareholders. That regime was inconsistent with the decision to restrict the treatment of losses of other companies.

From an economic perspective, the government should share in the profits and losses of enterprises on an uniform basis. This is necessary to provide a neutral environment for risk taking. The present rules are likely to discourage private risk taking, investment by new firms, risky and long-lived investment, takeovers and mergers of firms with tax losses and equity raising (other than from existing shareholders) by firms with tax losses.

The main argument that has been advanced for restrictions on loss carry-forward and loss-offset rules is that they may limit the exploitation of tax shelters, given that the actual tax base falls short of the ideal one. If this is an overriding concern, firms should be permitted to carry losses backward (ie be permitted to obtain a tax refund up to the amount of tax previously paid) and should be compensated for the delay involved in carrying losses forward.

The preferred direction for policy rests on a judgment on the size of the inefficiency caused by restrictive loss-offset and loss carry-forward rules and of the benefits of indirectly restricting the use of tax shelters by companies that are in a loss position. The balance of benefits, in our judgment, is likely to favour a policy of permitting full-offset, including the cashing out of losses.

4.2.2 How can we improve New Zealand's ability to attract and retain skilled labour?

The need to reduce tax rates

If New Zealand is serious about attracting and retaining skilled innovators and entrepreneurs, the preferable approach is to set a goal of reducing personal tax rates to a much lower and more uniform level.

As noted by the OECD (2000a), the government's recent decision to raise the top marginal tax reduced was a negative step in this regard:

> ... given its relative geographical isolation and resource endowments, New Zealand has more to do than other countries in order to make it an attractive location for both domestic and foreign labour and capital. This may also help to mitigate the net loss of skilled workers seen in migratory flows over the past few years. Against this backdrop, some recent policy developments do not appear to be helpful, for example: boosting the top marginal income tax rate; lowering the obligation of some benefit recipients to seek work; introducing income-related rents for public housing; stopping the privatisation process; re-nationalising accident insurance; and ending

> unilateral tariff reductions while introducing an export credit scheme. At the same time, some initiatives would not seem to be conducive to achieving the government's social policy objectives, for instance, the more generous student loans scheme.

This view that New Zealand has more to do than other countries in order to make itself an attractive location for both domestic and foreign labour and capital is supported by the minister of finance, Michael Cullen, who noted that the first part of the above statement "... seemed to me to be a self-evidently sensible one" (Cullen 2000c).

There is also a case for putting a cap on the total amount of income tax payable by individuals in the interests of attracting and retaining highly skilled labour.

With such a cap individuals with incomes over a specified threshold would all pay the same lump sum amount of tax. This threshold could be set at quite a high level, say $500,000, to ensure that the amount of tax paid by high-income individuals is more than sufficient for those individuals to:

- cover the cost of the public goods and services they consume; and
- make a significant contribution to funding the welfare services for individuals on low incomes.

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

4.2.3 Why not collect more revenue using 'green' and excise taxes?

If taxes on capital and labour income deter saving and investment, and reduce the country's ability to attract and retain skilled labour, why not reduce income tax and collect a greater proportion of revenue via taxes on pollution and other 'undesirable' activities?

At first sight, 'green' taxes (eg taxes on pollution) and excise taxes on alcohol, tobacco, and gambling seem to be a desirable source of revenue for the government since they appear to be able to raise revenue in a manner that improves, rather than reduces, economic efficiency. In other words, they seem to be capable of producing a 'double dividend' - raising revenue and improving economic efficiency.

The risk of 'government failure'

As noted in section 2.2.4, however, the design of such 'optimal' taxes is extremely informationally demanding.

For example, the design of optimal 'green' and excise taxes requires detailed information on:

- the marginal damage arising from the activity in question; and
- the marginal cost of abating that damage; and
- how responsive the level of damage is to the proposed rate of tax.

In practice, considerable uncertainty usually surrounds both the extent of damage arising from the undesirable activity and the costs of abatement. This makes it extremely difficult for the government to identify either the economically efficient level of abatement or the level of tax or subsidy required to produce that efficient level of abatement.

As noted by Pieler (2000):

> So-called green tax reforms promoted by much of the environmental movement assume that government micromanagement of economic decisions is the only way to go; that public officials can accurately predict what kinds of private-sector actions and investments will pollute less, or pollute more; and that financial incentives (and penalties) built into tax policy will have a predictable effect on the environment, and no unanticipated side-effects. Common sense, not to mention the

> environmental degradation witnessed in nations with planed economies, tell us otherwise.

Additional efficiency costs arise from the administrative and compliance costs associated with the operation of such taxes. Indeed, the costs of obtaining the information required to design such 'optimal' taxes could exceed the potential benefits from their application.

In view of the difficulties and costs associated with obtaining the information necessary to design 'optimal' 'green' taxes, governments often resort to setting target levels of emissions, or reductions in emissions, and implementing market-based initiatives that seek to achieve those targets at 'least cost' to the economy as a whole.

While such a 'least cost' approach to reform reduces the amount of information required by the government, it does not guarantee that achieving the specified target will be of net benefit to the nation as a whole. Before implementing a 'least cost' approach to pollution abatement, it is still necessary for the government to establish that a reduction in the level of emissions to the target level would actually benefit the nation as a whole. That is, it is still necessary to apply the broad principles outlined in section 2 before seeking to use the tax system to correct for market failure.

Unfortunately, as outlined in section 4.2.4, past governments have not always applied those general principles when designing 'green' taxes.

As noted by Pieler (2000), removing tax concessions and lowering tax rates can have a much more beneficial effect on the environment than the introduction of 'green' taxes:

> The failings of green tax-reform proposals obscure the larger truth: True tax reform itself, defined in terms of flattening tax rates and eliminating special tax favors, is a much sounder environmental policy than the highly-touted "tax reforms" environmental activists promote. Real tax reform, whether it takes the form of a flat-rate income tax, a simplified sales tax, or a cash-flow tax that rewards investment over consumption, would have a profound ecological impact. Real tax reform would:
>
> - eliminate economic friction and waste caused by government interference in market decisions, resulting in greater efficiency and less pollution;
>
> - accelerate the turnover of capital stock by reducing the tax burden on new investment and savings, thereby bringing new energy-saving and less-polluting technologies to the market much faster;

- boost economic growth overall, helping businesses and individuals generate new wealth, which is a sine qua non of dealing effectively with environmental problems either in the public or private sector.

The need to review existing excise taxes

The government should also review of the extent to which existing excise taxes on alcohol, tobacco and gambling are achieving their desired objectives.

In particular, we believe that priority should be given to a review of the current excise tax treatment of beer, wine and spirits which is discussed below. In addition, the excise taxes applying to fuels need to be reviewed. As noted in section 2.1.2, fuel exercise taxes were once a relatively efficient way of charging for road use, due to the practical problems associated with monitoring the actual use of roads by each individual. In view of recent advances in technology, however, there is now much greater scope to implement more efficient mechanisms for charging for road use (eg through the electronic tagging of vehicles). As a result, it may be possible to reduce reliance on fuel excise taxes as a means of charging for road use.

In particular, the general revenue element of the excise tax on petrol should be abolished. That is, petrol excise should not be imposed for the sole purpose of raising additional revenue. While petrol excises might be a convenient source of revenue for government since the demand for such fuel is relatively insensitive to changes in price, it is important to recognise that such excises impose significant costs on business, particularly road transport intensive activities. This reduces the competitiveness of those businesses in both the markets for their products and the resources they use.

The need to revise excise tax on beer, wine and spirits

Excise duty on beverages containing alcohol is a hangover from a much earlier period in New Zealand's social and tax history. The Review provides an opportunity to examine the tax on a principled basis.

Excise duty (and related customs duty) on beer, wine and spirits raise about $500 million a year or 1 percent of total revenue. The tax was once largely viewed as a general revenue tax. This reason for it is inappropriate now that GST has been introduced.

The Treasury argues that the use of beer, wine and spirits leads to external costs, most notably the costs of health services, which are not borne by the consumer. It believes that excise tax is efficient because it internalises such costs. This is the main contemporary argument for excise tax. In our view it is weak.

There are no economic grounds for applying excise tax to beer, wine and spirits where the consumer is of sound mind and is capable of making rational decisions, bears the full costs of his or her actions and is aware of the risks and benefits involved. In these circumstances, excise tax is inconsistent with efficiency and equity criteria.

The vast majority of adult New Zealanders gain substantial benefits from the consumption of beer, wine and spirits as shown by their willingness to buy these products. There is compelling evidence that responsible consumption of these products provides health benefits. There is considerable information available to consumers on the risks of inappropriate use of beverages containing alcohol, and their supply to minors and intoxicated people is prohibited.

Only a very small percentage of consumers engage in anti-social behaviour. Policies that target the misuse of beer, wine and spirits rather than responsible consumption are required to address anti-social behaviour. This approach is similar to that taken in respect of motor vehicle accidents. Greater mobility is rightly seen as a benefit of higher living standards and strategies to reduce accidents are targeted at their specific causes. The problem does not relate to people who drive, or even those who drive a lot, but to those who cause accidents. Only GST is applied to cars (besides specific charges such as registration fees). A similar approach in respect of beverages containing alcohol requires policies directly targeted at the misuse of such products rather than a tax on all drinkers.

Health services are provided free of charge or on a highly subsidised basis to facilitate access to such services. One unintended consequence of this policy is that people are encouraged to adopt lifestyles and engage in activities that may lead to a higher demand for health services than otherwise. Given this policy, there are no compelling grounds to recover health costs attributable to drinkers but not to recover similar costs from other people who adopt lifestyles or engage in activities that generate a demand for health services such as those who over-eat, under-exercise, or participate in risky recreational activities like skydiving and contact sports.

Would anyone seriously suggest that fast foods should be subject to excise tax because some people who eat them are likely develop health problems? Similarly, would anyone argue that people who are poor should pay higher taxes because such people generally have a higher incidence of illness and injury than other people?

If the consequences of the policy of subsidising health services are a serious concern, then the first best approach is to efficiently price health services. The problem is not one of externality but of mis-priced government services.

Studies of the effect on health of drinking conclude that non-drinkers have poorer health outcomes than responsible drinkers. An apparent implication of Treasury's approach is that non-drinkers should be subsidised as this would encourage them to drink and reduce the health costs that are imposed on taxpayers. Would anyone seriously suggest such a strategy?

The enforcement of traffic laws and other policies internalise costs that arise from the misuse of beer, wine and spirits. The critical issue is the identification of the appropriate policy response and instruments (if any) to address the misuse of beer, wine and spirits. Would it be sensible to impose excise tax on all motor vehicles simply because some drivers are involved in fatal and injury-related accidents?

The per capita consumption of beer, wine and spirits declined by 12.6 percent between 1990 and 2000, despite the adoption of a more liberal regulatory regime in 1989. The road toll is also trending downward even though more cars are using the roads and greater aggregate distances are being travelled. According to the Land Transport Safety Authority, alcohol-related road casualties fell by 55 percent between 1990 and 1998 and the share of such casualties fell from 43.6 percent to 28.4 of total causalities. These factors have not been reflected in the rates of excise tax which were last adjusted, aside from indexation, in 1991 when they were increased.

The government has insufficient information to impose efficient and equitable taxes to internalise the costs that arise from the misuse of beer, wine and spirits. There is, for example, considerably uncertainty about the causes and effects of social problems that are said to arise from inappropriate consumption. Do some people drink excessively in attempting to cope with their problems or do their social problems arise from the abuse of alcohol?

Excise tax is often a heavy burden on people with little discretionary income who choose to drink responsibly. It unambiguously breaches widely accepted equity criteria. Excise taxes are horizontally inequitable because people who are in exactly the same position in all respects except for their consumption of beer, wine and spirits pay different amounts of tax. They are also vertically inequitable because a person on a higher income may pay less total tax than a person on a lower income who consumes more beer, wine and spirits.

We believe that excise duty on beer, wine and spirits is not justified on efficiency or equity grounds. The Review should recommend a progressive phasing-out of excise tax.

4.2.4 Should a carbon charge be introduced to reduce greenhouse gas emissions?

One issue that the Review may be required to consider is the use of a carbon charge to reduce greenhouse gas emissions. In August 2000, the minister of energy and convenor of the Ministerial Group on Climate Change, Pete Hodgson, issued a media release and three Cabinet papers outlining the government's early decisions on the direction of its climate change plan (Hodgson (2000) and New Zealand Ministry of Economic Development (2000a,b, c)). In brief, the plan involves the revival of initiatives to improve energy efficiency and continuing work on more complex economic and regulatory options including a carbon charge, industry agreements on emissions reduction, and forward trading in emission units. The development of that plan is intended to enable New Zealand to ratify the 1997 Protocol to the United Nations Framework Convention on Climate Change by mid 2002. The Kyoto Protocol obliges New Zealand to stabilise its greenhouse gas emissions at 1990 levels, on average, over the period 2008 to 2012.

Specifically, the media release noted that:

> If there is a decision to include a carbon charge in a climate change package, the work will be forwarded to the Tax Review process. (Tax change

proposals emerging from the review would not be implemented until after the 2002 general election.)

Since 1991, the NZBR has been raising a number of major concerns relating to the government's approach to climate change. Those concerns are set out in detail in our:

- April 1999 submission on the Ministry for the Environment's consultation document *Climate Change: Domestic Policy Options Statement*; and
- October 1996 submission on the Working Group on CO_2 Policy's discussion document *Climate Change and CO_2 Policy*.

In brief, our main concern is that the case for government intervention to reduce New Zealand's greenhouse gas emissions has not been established:

- The impact of greenhouse gas emissions on both global and regional climate change is highly uncertain.
- There is no evidence to suggest that the forecast climate changes would be more likely to impose a net cost rather than a net benefit on New Zealand.
- There is no evidence to suggest that the implementation of a carbon charge would be of net benefit to New Zealand. Indeed, the introduction of carbon charges, tradeable emission permits and mandatory energy performance standards would impose significant costs on the community with no measurable compensating improvement in New Zealand's climate.
- There is no case for New Zealand, a middle-income country, imposing costs on its economy in the absence of concerted action by countries that have higher levels of income and are large emitters. It seems doubtful at this stage that the United States will ratify the Kyoto Protocol. China and India will not do so.

As outlined below, we believe that New Zealand's experience with the development of its climate change policy provides a good illustration of the types of problems that can arise when the government fails to apply the broad policy development principles outlined in section 2.

The impact of greenhouse gas emissions on climate change is highly uncertain

Considerable uncertainty still surrounds the impact of greenhouse gas emissions on both global and regional climate change. The scientific community has largely discounted initial fears of massive increases in sea levels. Taylor (1998) reports that while there is some evidence that sea levels have increased during the past century (with an uncertainty range of 10-25 cm), there is little evidence that the rate of rise has accelerated as a result of global warming.

Contrary to popular belief, there is also insufficient evidence that greenhouse gas emissions have caused increased climate variability. As noted by the IPCC in its Second Assessment Report (IPCC 1995):

> There are inadequate data to determine whether consistent global changes in climate variability or weather extremes have occurred over the 20th century. On regional scales there is clear evidence of changes in some extremes and climate variability indicators. Some of these changes have been toward greater variability, some have been toward lower variability. However, to date it has not been possible to firmly establish a clear connection between these regional indicators.

Observed temperatures also remain far below those predicted by the computer models that form the basis for the UN FCC and the moderate warming that appears to have occurred seems to be largely confined to the cold northern latitudes during winter nights (Taylor (1998), Michaels (1999)). The key issue is not whether temperatures might rise, but by how much. Small increases in warming would be well within the range of past fluctuations. National Institute for Water and Atmospheric Research (NIWA) research suggests average temperatures in New Zealand will rise by only about 60 percent of the global average.

There are significant discrepancies between the temperature observations provided by surface meteorological stations and those provided by satellite and weather balloons. This was highlighted by Professor Michaels of the University of Virginia in his testimony to the US House of Representatives Subcommittee on National Economic Growth, Natural Resources and Regulatory Affairs (Michaels 1999).

In his submission, Professor Michaels noted:

> The disparity between the surface, satellite and weather balloon readings is likely to have some basis in reality. The concordance between the satellites

> and balloons cannot be from change, so there must be some process occurring in the lowest layers (below 5,000 feet) that is not being picked up in those two records.

Professor Michaels argues that discrepancies cast considerable doubt on the accuracy of the global warming forecasts:

> Together these findings all prove that over the entire concurrency of the surface, satellite and balloon records, there is a warming confined to the bottom 5,000 feet of the atmosphere, but over two-thirds of it is in winter, and three quarters of that is in the most profoundly cold continental air that we know of …
>
> Together these findings also demonstrate a persistent, damaging and pervasive error in all climate models including those that serve as a basis for the Kyoto Protocol …
>
> They all have failed to predict what has happened between 5,000 feet and the bottom of the stratosphere. This comprises over 80% of the troposphere, or the earth's active weather zone.

There is no evidence that climate change will impose a net cost on New Zealand

It is far from clear that the projected changes in New Zealand's climate will impose a net welfare cost on the nation as a whole. To date, there has been no thorough analysis of the costs and benefits of the projected changes in New Zealand's climate on national welfare.

As noted by NIWA, considerable uncertainty surrounds both New Zealand climate change projections and the impact of those changes on New Zealand:

> Quantitative projections of the impacts of climate change over a region such as New Zealand are difficult. This is because of the uncertainties in regional climate change projections, the limited knowledge about sensitivities of some systems (both natural ecosystems and managed agricultural activities) to climate, and the interactions of multiple climatic and non-climatic factors on such systems.

An assessment of the impact of climate change on New Zealand also needs to take account of international factors such as positive and negative effects on New Zealand's trade and the consequences of agreements in forestry 'sinks'. This assessment has not been done.

The IPCC's 1997 report on *The Regional Impacts of Climate Change: An Assessment of Vulnerability* does not quantify the regional impacts of climate change (IPCC 1997). Rather, it only provides an illustrative assessment of the vulnerability of regions to assumed climate changes. As noted by the IPCC, this approach was necessary in view of the considerable uncertainties surrounding both the nature of those future climate changes and the regional impacts of those changes:

> ... it is important to bear in mind that uncertainties regarding the character, magnitude and rates of future climate change remain. These uncertainties impose limitations on the ability of scientists to project impacts of climate change, particularly at regional and smaller scales.
>
> It is in part because of the uncertainties regarding how climate will change that this report takes the approach of assessing vulnerabilities rather than assessing quantitatively the expected impacts of climate change. The estimates are best interpreted as illustrative of the potential character and approximate magnitudes of impacts that may result from specific scenarios of climate change. They serve as indicators of sensitivities and possible vulnerabilities.

While admitting that little work had been done to date on the impact of the latest climate change scenarios, the executive summary to the Australasian chapter of that report noted that any resulting climate changes are likely to have both positive and negative effects on the New Zealand economy:

> ... New Zealand is a mid-latitude country with relatively large alpine areas and greater water resources [than Australia]. Despite New Zealand's large dependence on export commodities - which may be affected by world commodity prices - general warming would allow adaptation through the introduction of more heat-tolerant crops or the migration of species and activities to higher altitudes or latitudes. Increased agricultural production appears likely. One of the most obvious impacts of warming in New Zealand would be the retreat of snowfields and glaciers, which may have impacts on tourism, water resources and hydroelectric power generation.

An assessment of the impact of climate change on New Zealand also needs to take account of international factors such as positive and negative effects on New Zealand's trade and the consequences of agreements in forestry 'sinks'. This assessment has not been done.

There is no evidence that a carbon charge would be of net benefit to New Zealand

Of particular concern is the absence of a thorough analysis of the effects that the implementation of carbon charges, tradeable emission permits or mandatory energy efficiency standards would have on New Zealand.

There is no evidence that the introduction of those initiatives would produce a discernible benefit in the form of an improvement in either world or local climate trends. This is hardly surprising given that New Zealand's emissions of greenhouse gases are simply too small to influence either its own climate or the global climate. Indeed, even if all countries were to ratify the Kyoto agreement, and achieve their emission targets, those targets are too limited to produce a significant reduction in global warming.

However, it is clear that the introduction of carbon charges, tradeable emission permits and mandatory energy efficiency standards would all impose real costs on New Zealand businesses and consumers. In particular, it would deter investment in New Zealand and encourage businesses to relocate offshore, without producing any real improvement in local or global climate change.

Even if a good case could be made that New Zealanders would be worse off if the projected global warming occurred, the government would still have to establish that the costs of abatement would be lower than the costs of adjusting to those climate changes. This has not been done.

Lessons for tax policy development

We believe New Zealand's experience with the development of its climate change policy provides a number of important lessons for tax policy development.

In particular, it illustrates how easily government failure can occur when the government fails to apply the broad policy development principles outlined in section 2.

For example, it highlights the problems that arise when:

- the decision to intervene is made independently of the choice of policy instrument; and
- the risks of rushing into the development of 'least cost' solutions to environmental problems, and entering into commitments to implement those solutions, when considerable uncertainty still surrounds both the nature and extent of the problem and the New Zealand government's ability to influence it.

We support the government's plan to forward any decision about a carbon charge to the Review, as well as the proposal to hold an inquiry into the impacts of climate change and what New Zealand should be doing to adapt to and manage those risks. Our preference would be for a full ministerial inquiry with an independent panel of experts, as opposed to a review run by the Ministry for the Environment.

4.2.5 How can we improve the quality of investment?

Need to review the current tax treatment of foreign investment by residents

As noted in section 3.2.2, one of the main problems with the current tax system is that it imposes different effective rates of New Zealand tax on the income that residents derive from their investments in different jurisdictions. In particular, much higher effective tax rates tend to be applied to investments in non-grey list countries, since the income from those investments is taxed as it accrues under the provisions of the CFC and FIF regimes. The FIF regime also applies to investments in life insurance and superannuation funds in grey-list countries.

One of the original policy objectives of New Zealand's international tax regime was to improve the quality of investment by ensuring that the income that residents derived from foreign investments was taxed at roughly the same rate as income from domestic investments. That is, the objective was to improve *New Zealand welfare* by reducing the extent to which *New Zealand taxes* distorted patterns of investment by ensuring that New Zealand residents faced roughly the same rate of tax on all of their worldwide income, regardless of its source. This approach differs significantly from that in other jurisdictions where the objective is to reduce the scope for tax avoidance via 'passive' investments in tax havens.

It was recognised that *foreign taxes* also could distort the pattern of investment by New Zealand residents. However, it was concluded that it was not possible, or desirable, for a small open economy such as New Zealand to try to offset those distortions by applying different rates of tax to income from different sources in an attempt to improve *world welfare*. Rather, it was considered that the best approach to that problem was by way of participating in international negotiations aimed at reducing instances of 'double' taxation (eg double tax treaties, and participation in OECD discussions). The rationale underlying that decision is much the same as the rationale underlying the decision not to try to influence world trade reform by unilaterally imposing retaliatory import duties. New

Zealand is simply too small for such unilateral action to have any effect other than reduce the welfare of New Zealand as a whole.

The uniform rate of tax on the worldwide income of residents was to be achieved through the introduction of the CFC and FIF regimes in combination with an extension of the tax base to include a wider range of income from capital (via the introduction of a comprehensive capital gains tax). In particular, the CFC and FIF regimes were designed to ensure that residents could not reduce their New Zealand tax liabilities by accumulating income in offshore companies and investment funds. This is the reason why those regimes tax that income as it accrues, rather than when it is ultimately distributed to the New Zealand investor. Taxation on a realisation basis would enable residents to invest offshore and indefinitely defer New Zealand tax on the income derived from those offshore investments.

In order to reduce compliance costs and for political reasons, investments in grey-list countries were exempted from the provisions of the CFC and FIF regimes. Distributed income from those investments was included in the taxable income of New Zealand recipients and taxed in the same manner as their other income.

It is important to note, however, that since the CFC and FIF regimes were designed there have been a number of important decisions which influence their effect including:

- the decision not to introduce comprehensive taxation of income from capital;
- the decision to introduce the underlying foreign tax credit (UFTC) regime. This resulted in a fundamental change in the policy objectives of the CFC regime. Up until then, the primary objective of both the CFC and FIF regimes was to ensure that the foreign sourced income of residents was taxed at relatively similar rates to domestic investments. Those regimes were not designed with a view to ensuring that resident investors faced the same total amount of foreign and domestic taxes on their foreign investments. That is, the CFC and FIF regimes were not designed with a view to reducing international 'double taxation'. Nor were they designed solely with an anti-avoidance objective in mind like the international tax regimes that exist in other countries. Rather, they were designed with a view to reducing the extent to which New Zealand tax distorted the domestic and foreign investment decisions of residents; and

- the decision to raise the top personal tax rate from 33 to 39 percent.

In combination, these subsequent decisions mean that the effective tax rates applying to investments in non grey-list countries are now much higher than was originally envisaged, and the effective tax rates applying to investments in grey-list countries and certain domestic investments are now much lower.

We believe there is a need to review the tax treatment of foreign investment by residents in the light of those developments. In particular, there is a need to review the FIF regime. The Review needs to consider whether it is really in New Zealand's best interests to continue to tax these portfolio investments at such high effective rates of tax when comparable investments in both grey-list countries and New Zealand are taxed at much lower rates. The current tax treatment of foreign portfolio investments by residents is a significant concern given the sensitivity of those investments to differences in effective tax rates. Even small differences in effective tax rates are likely to produce significant distortions in the pattern of portfolio investment across jurisdictions.

The sensitivity of portfolio investment decisions to differences in tax rates has been a major consideration in the redesign of the tax treatment of foreign investment in New Zealand by non-residents. Attention now needs to be given to redesigning the tax treatment of portfolio investment by residents.

Ideally, the portfolio investment decisions of New Zealand residents should be driven by the merits of those investments rather than the vagaries of the New Zealand international tax regime. In principle, this can only be achieved by the taxation of the worldwide income of residents as it accrues. This would require the removal of both the grey list and the UFTC regime, and the extension of the FIF and CFC regime to all domestic and foreign investments. Only this approach would ensure that a uniform effective marginal tax rate is imposed on the income that residents derive from all of their income, regardless of whether it is sourced from investments in New Zealand or offshore.

In practice, however, such an approach is unlikely to be feasible in view of the practical difficulties associated with taxing all forms of income as it accrues. These difficulties include the problems associated with obtaining accurate measures of the extent to which asset values are changing over time, as well as the additional compliance costs associated with the measurement of income as it accrues.

These practical difficulties mean that complex trade-offs need to be made when determining the manner in which residents should be taxed on their foreign sourced income.

At the moment, residents tend to be over-taxed on their investments in non-grey list countries, since the income from those investments is taxed as it accrues under the provisions of the CFC and FIF regimes, whereas the income from most domestic investments is only taxed when it is realised.

This seems to suggest that the CFC and FIF regimes should be modified so that income is only taxed as it is realised. Such an amendment has the potential to improve economic efficiency by reducing the current difference in the effective marginal tax rates applying to non-grey list investments and comparable domestic investments. However, the potential benefits from such an amendment need to be traded off against the potential risk that such an amendment could actually reduce economic efficiency. If investments in non-grey list countries were only taxed on a realisation basis, residents would be able to accumulate income offshore, and defer indefinitely the payment of New Zealand tax on that income. In effect, this would reduce the effective rates of tax applying to investments in non-grey list countries to a level well below that applying to comparable investments in New Zealand. Indeed, it is possible that such an amendment may actually reduce economic efficiency by increasing the size of the current difference between the effective marginal tax rates applying to investments in non-grey list countries and those applying to comparable domestic investments.

Similarly, at the moment, residents with investments in grey-list countries can face lower effective rates of New Zealand tax than apply to similar investments in New Zealand since:

- the income from those grey-list investments is not subject to the provisions of the CFC or FIF regimes; and
- resident companies can claim credits for any foreign tax they pay on income from those investments under the provisions of the UFTC regime.

Once again, at first sight this suggests that the grey-list exemption and the UFTC regime should be removed, and the CFC and FIF regimes should be applied to income from investment in all countries. This has the potential to improve efficiency by applying more uniform effective marginal tax rates to the income that residents derive from their foreign investments in different jurisdictions. However, these potential benefits need to be traded off against the additional compliance costs arising from applying the CFC and FIF regimes to grey-list investments. That is, the additional compliance costs arising from such an amendment will offset those potential efficiency gains to some extent. Indeed, the current grey-list exemption appears to be based on the belief that those additional compliance costs would more than offset the potential efficiency gains from subjecting grey-list investments to the CFC and FIF regimes.

In summary, when determining the appropriate tax treatment of offshore investments by residents, a number of complex trade-offs have to be made. The key issue that needs to be examined by the Review is whether the trade-offs that have been made in the course of designing the current international tax regime as it applies to the foreign source income of residents are still appropriate.

Need to consider the scope for further reductions in the rates of tax applying to foreign equity investment

New Zealand has already made considerable progress in reducing the domestic cost of capital by lowering the rates of tax imposed on non-resident debt investment (through the introduction of the AIL regime) and equity investment (through the introduction of the FITC regime).

We believe consideration needs to be given to the scope for reducing the maximum rate of tax applying to non-resident equity investment to a level below the current company tax rate of 33 percent. This will require the Review to examine the extent to which New Zealand is able to raise revenue by taxing the income that non-residents derive from their equity investments in New Zealand without raising the cost of capital in New Zealand.

The ability of New Zealand to raise revenue by taxing the New Zealand sourced income of foreign investors depends on how sensitive that investment is to the imposition of New Zealand tax. As a small open capital-importing nation, New Zealand must compete with other countries to attract the financial and physical capital needed for its development. In order to attract foreign investment, New Zealand has to be prepared to provide foreign investors with after-tax rates of return that are at least as good as those available from alternative investments in other jurisdictions.

In the short to medium term, the sensitivity of foreign investment to New Zealand taxes is likely to vary considerably across different types of investment. For example, foreign debt investment in New Zealand is likely to be highly sensitive to New Zealand tax. Indeed, in order to raise foreign debt finance, New Zealand borrowers often have to agree that they will compensate the foreign lender for any New Zealand withholding tax imposed on that income. In other words, New Zealand borrowers often bear most of the burden of New Zealand withholding taxes imposed on the interest income of the non-resident lenders. This is the reason why New Zealand introduced the approved issuer levy regime. In effect, it reduces the amount of NRWT levied on the interest income of non-residents to 2 percent.

Similarly, foreign portfolio investment is also likely to be highly sensitive to the rate of New Zealand tax, since there are numerous highly substitutable investments in other jurisdictions and the transactions costs of switching to those alternative investments are relatively low. By contrast, it is reasonable to expect that, in the short to medium term, foreign direct investment in New Zealand through either a branch or a subsidiary will be less sensitive to New Zealand tax since:

- the decision to undertake foreign direct investment in New Zealand is likely to be driven by a much wider range of considerations besides tax, including the resources available in New Zealand and the economic and political environment; and
- the transactions costs associated with relocating to another jurisdiction are likely to be relatively high.

In the longer term, however, even foreign direct investment is likely to be sensitive to the level of New Zealand tax imposed on income from such investment.

Foreign investment is much more important to New Zealand than it is to most other OECD countries. New Zealand is a major net capital importer and it is in the country's best interests to reduce the extent to which the tax system deters such investment and reduces the quality of that investment. Ideally, foreign investment decisions should be driven by the relative merits of alternative New Zealand investments rather than tax considerations.

As indicated in Table 5, Australia is the most important source of foreign direct investment in New Zealand, followed by the United States and the United Kingdom. Although foreign direct investment from OECD countries has been increasing since 1995, investment from ASEAN countries has been declining since 1996.

New Zealand's relatively heavy reliance on foreign direct investment from Australia, coupled with Australia's decision to reduce its rate of company tax to 30 percent, highlights the importance of pursuing further reductions in the rates of tax that New Zealand applies to the income produced by that investment.

Table 5: Total foreign direct investment in New Zealand(1)(2) at 31 March NZ$(million)

	Annual				
	1995	*1996*	*1997*	*1998(r)*	*1999*
	By major economic groups				
APEC	31,412	37,858	38,557	42,528	42,008
ASEAN	2,842	3,517	3,635	2,986	1,797
EU	6,761	7,940	9,822	11,627	12,884
OECD	33,916	41,055	43,750	50,323	52,162
	By major countries				
Australia	13,124	14,717	15,713	19,626	22,504
Canada	1,118	1,894	965	1,600	1,446
Germany	202	250	243	265	298
Hong Kong	1,612	1,439	1,355	1,117	1,109
Japan	1,512	1,598	1,690	1,227	2,347
Netherlands	1,689	1,345	1,371	1,345	3,109
Singapore	2,595	3,277	2,547	2,162	1,163
Switzerland	346	390	477	379	297
United Kingdom	4,595	5,894	6,894	8,509	8,357
United States	11,034	14,407	14,955	15,809	12,631
Total all countries	40,076	49,534	54,164	62,992	62,500

Notes: (1) Published under section 37(4) of the Statistics Act 1975 with the consent of all significant contributors.

(2) Data may not add to stated totals due to rounding.

(3) (r) Revised.

Source: Statistics New Zealand

Need to consider the scope for further improvements in the measurement of New Zealand sourced income

Not all of the differences in effective marginal tax rates applying to the foreign sourced income of residents, and the New Zealand sourced income of non-residents, come from differences in the statutory rates of tax applying to that income. Some of those differences are due to inaccuracies in the manner in which New Zealand currently measures the amount of New Zealand sourced income derived by both residents and non-residents.

In particular, the current rule for determining the source of dividend income is deficient. In principle, the economic source of dividend income is the country in which the value adding activity that produces that income is performed. In practice, however, New Zealand like most other OECD countries assumes that the source of dividend income is the country in which the company paying those dividends is resident. That is, it is assumed that all of the dividend income distributed by a company was generated by economic activities undertaken by that company in the country in which it is resident.

This arbitrary rule for determining the source of dividend income probably worked reasonably well in the past when most companies only engaged in activities in their country of residence and most of the shareholders in that company were also resident in that country. However, the accuracy of this arbitrary rule has been eroded significantly over the last few decades by rapid growth in foreign investment and the emergence of multinational companies that engage in economic activities in a large number of jurisdictions. It is now possible for a company resident in one country to have significant investments in other jurisdictions and significant numbers of non-resident shareholders. As a result, the residence of a company for tax purposes is now no longer a reliable guide for determining the actual economic source of the dividend income it distributes. That is, it can result in inaccuracies in the measurement of the amount of New Zealand sourced income derived by a taxpayer.

New Zealand's ability to alter this definition of the source of dividend income is constrained in practice by the fact that its double tax treaties with other jurisdictions are based on the OECD model. That model defines the source of dividend income to be the country in which the company paying the dividends is resident. It would be difficult for New Zealand to alter that definition unilaterally without renegotiating its double tax treaties. As a result, rather than redefine its dividend source rule, New Zealand has sought to deal with these problems by altering the effective rates of tax applying to that dividend income.

For example, a company resident in New Zealand can have significant investments in other jurisdictions and can have large numbers of foreign shareholders. As a result, a significant proportion of the income of those resident companies can be the foreign sourced income of non-resident shareholders which should not be subject to New Zealand tax. In order to address this 'conduit' problem, New Zealand has introduced rules that reduce the amount of New Zealand tax payable under the CFC and FIF rules on the foreign sourced income of non-residents that in effect 'flows through' New Zealand resident companies. These 'conduit' rules are intended to relieve the conduit problem to some extent while not undermining the integrity of the CFC and FIF regimes by creating opportunities for residents to avoid New Zealand tax on their foreign sourced income.

Conversely, a company resident in another country such as Australia can have significant investments in New Zealand and large numbers of New Zealand shareholders. As a result, a large proportion of the income derived by that Australian company can be New Zealand sourced income and should be subject to the New Zealand, rather than Australian, tax rules.

In particular, New Zealand shareholders in Australian companies that have significant investments in New Zealand should be able to claim imputation credits for the New Zealand tax levied on the income derived from those investments. At the moment, however, they are unable to claim those credits. Similarly, Australian shareholders are unable to claim franking credits for any Australian tax paid on the Australian sourced income of companies resident in New Zealand. This means that New Zealand residents are discouraged from investing in New Zealand activities via Australian resident companies, and Australians are discouraged from investing in Australian activities via New Zealand resident companies. This is referred to as the 'triangular' tax problem.

The 'triangular' tax problem is of particular concern to New Zealand given the number of companies resident in New Zealand that are seeking to expand their operations into Australia and raise more equity finance by issuing shares to Australian residents. At the moment, those New Zealand companies are unable to provide their Australian shareholders with franking credits arising from the Australian tax they pay on the income they derive from their activities in Australia. In effect, this provides a tax incentive for those firms to relocate their companies to Australia.

As announced in the joint media statement *Australia and New Zealand to examine trans-Tasman tax issues* issued by the Treasurers of Australia and New Zealand, officials will be developing potential solutions to this 'triangular' problem and are expected to report back by 30 June 2001 (Cullen 2000a). This means that the triangular tax problem will have to be addressed by officials before the Review has had the opportunity to report to the government.

However, it does not mean that all of the problems arising from the current definition of the source of dividend income will be resolved prior to the Review's reporting date . The current conduit and proposed triangular tax relief mechanisms only address a subset of those problems. For example, proposals to provide relief for the trans-Tasman triangular tax problem will do little to help New Zealanders who are shareholders in, say, United States or Asian resident companies that also have significant investments in New Zealand. Those shareholders will continue to be denied New Zealand imputation credits on the income the non-resident company derives from its activities in New Zealand.

As a result, we believe it would be useful for the Review to:

- document the problems arising from the current approach to defining the source of dividend income;
- outline the reasons why it is difficult for New Zealand to unilaterally resolve this tax base problem without deviating from the OECD model which underlies New Zealand's double tax treaties (ie it is difficult for New Zealand to unilaterally redefine the source of dividend income);
- discuss the manner in which New Zealand has sought to address these problems to date by altering the rates of tax applying to dividend income (eg through the introduction of conduit);
- identify the problems that remain with the determination and accurate measurement of New Zealand and foreign sourced dividend income; and
- identify broad options for addressing those problems.

Even if the scope for further reform proves to be limited, a discussion along the lines outlined above would serve to highlight the principles that should guide further reform in this area. It would also serve to highlight the key trade-offs that inevitably have to be made between the benefits from measuring New Zealand and foreign sourced dividend income more accurately and the additional administrative and compliance costs associated with obtaining those more accurate estimates.

We think the following broad approach should be adopted:

- The guiding principle should continue to be the maximisation of national welfare. This principle is applied in other areas of tax policy and to government policy generally. It recognises that the government's primary responsibility is to further the overall interests of all New Zealanders.

- The move towards the taxation of residents on their worldwide income is consistent with the national welfare approach and is generally sound. It is acknowledged, however, that practical considerations, as discussed above, and some policy considerations limit the extent to which the principle can and should be applied.

- The grey-list exemption and credits for underlying tax paid are inconsistent with the residence principle and should be addressed.

- The residence principle implies exemption from tax of New Zealand sourced income of non-residents. The introduction of the AIL and the FITC are consistent with that approach. As discussed in section 4.2.1, there may be advantages in increasing the FITC further to lower the tax on inward foreign investment and hence the cost of capital.

- A strict application of the residence principle is not appropriate if non-resident investors are able to claim credits for New Zealand tax. Where credits apply, New Zealand may be able to collect some tax from non-residents without increasing the cost of capital. Our understanding is that the scope for taking advantage of foreign tax credits is limited.

- The possibility of taxing rents earned by foreign investors has also been advanced as a reason for continuing to tax non-resident investors. We doubt whether it is desirable and feasible to tax such rents without imposing significant efficiency costs.

- The relative importance of the tax credit and rent issues has been under study by Treasury for a long time. Judgments need to be made on these matters as a matter of some urgency and the direction of international tax policy progressed. We believe the evidence points to a case for moving further towards the residence end of the so-called 'see-saw' model by reducing tax on inward foreign investment, but probably not the complete removal of tax on foreign investors because there may be a case for endeavouring to balance up deadweight costs across all taxes and because of the possible availability of limited credits.

Need to consider the imposition of GST on certain imported goods and services

As noted in section 3.2.2, the absence of GST on imported services and digital goods reduces the efficiency with which the economy operates by distorting patterns of consumption, production and resource use in New Zealand.

Although the efficiency of the GST regime could be improved in theory by imposing GST on all imported services and digital goods that are subject to GST in New Zealand, in practice this is unlikely to be feasible. The administrative and compliance costs associated with the collection of GST on many types of imported services and 'digital' goods are likely to be prohibitive. Similarly, the administrative costs of the New Zealand Customs Service levying and collecting GST on all imported goods may be prohibitive.

However, there does seem to be some scope for extending the GST regime to apply to certain types of imported services. Of course, when considering such 'piecemeal' options for reform, considerable care needs to be exercised to ensure that the potential gains in economic efficiency arising from such reforms will be more than sufficient to offset any potential losses in efficiency. A piecemeal extension of GST to a greater range of services reduces consumption and production distortions between services that are subject to GST.

However, in so doing, it also creates new distortions between those services that are subject to GST and those that are still exempt.

One option for reform that needs to be explored by the Review is the application of GST to imported telecommunication services (eg 'call back' services which allow residents to make international phone calls via a non-resident telecommunications supplier). Other jurisdictions such as the United Kingdom, and more recently Australia, apply GST to imported telecommunication services by requiring non-resident companies who wish to supply those services to levy GST on the services supplied to residents (eg by requiring those entities to be registered for GST purposes). For example, the Australian GST regime includes a separate division dealing with telecommunications supplies (Division 85). This deems the supply of those services to be "connected with Australia" when the recipient of those supplies "will effectively use or enjoy the supply in Australia". This solution appears to be feasible in the case of telecommunication services given the limited number of large entities supplying those services internationally. However, such a solution would not be feasible in the case of most other services and digital goods in view of the large numbers of relatively small suppliers.

The Review should also examine the scope for taxing other imported services through the application of a 'reverse charge' on those entities importing such services. Australia, Canada, and the member states of the European Union all use 'reverse charge' regimes to impose GST on a range of imported services, including some 'intangible' goods. Under these 'reverse charge' regimes, entities registered for GST are in effect required to levy GST on the services they import. Canada and Switzerland also place an obligation on individuals to apply a reverse change on their imports of certain services.

In particular, the Review should explore the feasibility of applying a reverse charge to entities registered for GST that import services that are subject to GST but are not eligible for input tax credits (ie exempt supplies of services such as financial services). This is the type of 'limited' reverse charge regime that has been introduced in Australia.

Such a regime would remove most of the tax incentive that entities registered for GST would have to substitute imported services for domestically supplied services. In addition, it would avoid the additional administrative and compliance costs associated with applying a reverse charge to imported services that are eligible for input tax credits.

Some countries also extend the reverse charge to cover imported services that are eligible for input tax credits. This is intended to eliminate any remaining incentives that entities registered for GST may have to substitute imported services for domestically produced services (eg due to the unwillingness of some entities to bear the compliance costs and delays associated with claiming GST input tax credits). However, the administrative and compliance costs associated with collecting a reverse charge on those imported services, and then refunding that reverse charge via the provision of an input tax credit, may more than offset any potential benefits from imposing a reverse charge on those imported services.

ATTACHMENT A: TERMS OF REFERENCE

Functions

The Tax Review has been appointed to carry out a public review into the tax system so that the government has an appropriate framework within which to build tax policy.

The functions of the Review will be:

i to examine and inquire into the structure and effects of the present tax system in New Zealand;

ii to formulate proposals for improving that system, either by way of making changes to the present system, abolishing any existing form of tax, or introducing new forms of tax; and

iii to report to Parliament through the Minister of Finance, the Minister of Revenue and the Minister of Economic Development.

Context

The last fifteen years have seen an overhaul of the New Zealand tax system. The main changes have been to remove special allowances and exemptions and varied tax rates. The result has been to broaden the tax base, flatten tax scales and greater resource allocative neutrality.

Critics say that the present tax system allows individuals to arrange their legal affairs so as to escape full rates of personal income tax, treats some types of production unevenly, and favours some forms of long-term saving over others.

A second concern is that the tax system as a whole has become less progressive, while at the same time the interface between the tax and benefit systems is generating very high effective marginal tax rates for some low income people and families.

Thirdly, threats to the tax base are found in new forms of transacting (such as internet trading and internet banking) and the use of new tax havens. A related problem is whether increased globalisation requires re-examination of the very possibility of New Zealand setting its own tax rates and what will happen if it does.

Finally, there is a growing debate about how relevant the tax system is to the core features of the economic structure. (Rival) contenders to augment or replace elements of the current tax structure are sector-specific taxes to be used as an instrument for sectoral assistance, cash flow taxation, financial transactions taxes, and eco-taxes.

There is both the need for and scope to review the tax system at the level of broad principle as well as in some detail. For this reason, it is proposed to divide this process into two stages. The Tax Review is the first stage of the process and will explore the broad principles of the tax system. Stage two will consider the detail of implementing any changes proposed in stage one.

Purpose

In the budget speech the government announced:

> *We will set up a broad-based and wide ranging tax review to advise on the principles and structures best suited to sustaining a robust revenue base over the long term.*

The review will concentrate on how it is possible to ensure a sustainable and continuous flow of revenue to meet government requirements in the face of changing economic, social and technological conditions. It will form the basis of advice to the government in broad terms about whether the New Zealand tax system can be improved.

Ideally the tax system should raise revenue simply, efficiently, fairly and reliably in an environment of changing technology, growing globalisation and increasing complexity. It should do this in ways that do not materially undermine the environment, social cohesion or the effective use of resources.

Task of the Tax Review

The Tax Review will:

(a) Assess the extent to which the tax system can contribute to broader social and economic objectives such as encouraging secure, high-quality employment, generating a fair distribution of income, maintaining a sustainable environment and promoting higher savings;

(b) Recommend structural changes for the tax system, if appropriate. In doing so the Review will focus on the following questions:

i Can the tax system be made fairer in its role of redistributing income? This includes considering whether the income tax base should be broadened and the extent to which marginal rates should increase with levels of income, wealth and expenditure. The Review should consider the best mix between different tax bases such as income, consumption, financial transactions and wealth.

ii How can the tax system be designed to encourage desirable behaviour (eg work and savings) and discourage undesirable behaviour (eg the wasteful use of non-renewable resources)?

iii How can the level of tax that is reasonably required by government for the provision of essential social services such as health, education, superannuation and social welfare be achieved reliably in the medium and long term bearing in mind the need for the tax system to be an effective instrument of fiscal policy in the management of the economy?

iv Do the tax system and tax rates need to be modified in light of new technology and international competition?

(c) The Tax Review will report on progress to the Minister of Finance, the Minister of Revenue and the Minister of Economic Development at regular intervals during the course of the review.

The conclusions need to be sufficiently general so that they can serve as a guide to overall tax policy, but sufficiently particular so that they provide a clear idea of the actual tax policies that they would lead to. The Review will submit its final report to the Minister of Finance, the Minister of Revenue and the Minister of Economic Development by the end of September 2001.

Process expectations

The process should be inclusive, with opportunity for the public and key stakeholders to provide input, perhaps by way of the Review commissioning studies, preparing and releasing issues papers and arranging various discussion fora.

Since tax policy is a well-developed field, the Review would gather and assess the views of stakeholders and previous studies, rather than devising principles and policies from scratch. The Review's reporting deadline (by the end of September 2001) reinforces this.

The government would make available relevant tax-policy officials from Treasury and IRD to provide analytic and secretariat support, and would expect them to contribute significantly to the Review. The support will include a secretary to the Review, reporting to the Chair of the Review, to co-ordinate the support services to be provided. The Review team will have the ability and the budget to engage external parties to provide advice and assistance on specific issues.

Officials and the Review team would keep Ministers informed of the progress of the Review.

The government will consider the report of the Review, and indicate publicly its views on what principles should guide tax policy and what the general structure of the tax system should be.

Stage two of the process will develop the conclusions reached during the tax review and construct a set of workable proposals that can be put before the New Zealand public in the context of the 2002 general election.

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