

A Tax System for New Zealand's Future

Report of the
Victoria University of Wellington
Tax Working Group

January 2010

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Foreword

The Tax Working Group (TWG) was established by Victoria University of Wellington's Centre for Accounting Governance and Taxation Research, in conjunction with the Treasury and Inland Revenue, in May 2009. Although an independent Group, it was formed with the support of the Minister of Finance, Hon Bill English, and the Minister of Revenue, Hon Peter Dunne. The Group's task was to identify the major issues that Ministers will need to consider in reviewing medium-term tax policy and to better inform public debate on tax.

The TWG was set up following an international conference on tax policy in New Zealand held in February 2009 by Victoria University's Centre for Accounting, Governance and Taxation Research and the Institute for the Study of Competition and Regulation, with support from Inland Revenue and Treasury. This conference examined a range of areas, including personal taxes and transfers and company taxes, and participants identified significant concerns with the efficiency, equity and integrity of the current taxation system, concerns that required urgent attention.

The TWG brought together expert tax practitioners, academics, businesspeople and officials – those whose job it is to examine and set tax policy and those who deal with its impacts – to see if there was a common understanding of the issues and options for reform. We held six meetings between June and December 2009, where the Group discussed various aspects of the tax system – including the Government's medium-term goal of aligning the top personal, corporate and trust rates at 30%.

The Group has not focused on any single aspect of the tax system, or single option for change, but has looked at the system as a whole and a number of options for reform. Summaries of the Group's deliberations and background papers have been posted on the TWG internet site <http://www.victoria.ac.nz/sacl/cagtr/twg/>.

There is a strong view within the Group that the current tax system is not working effectively and that reform is necessary if New Zealand is to have a fair tax system that minimises the costs of raising taxes, reduces barriers to productivity and growth and positions it well for future challenges. This task of tax reform is more challenging because the fiscal environment and public debt forecasts mean that any tax changes cannot, in the medium-term, reduce revenue unless there is a commensurate fall in government expenditure.

Over the period that the TWG has been in existence, there have also been increasing expectations around the Group's deliberations and options for reform. In part this was because of the way the Group worked, with material being released after each session and the discussion that this created. It was also in part because of the review of taxation in Australia and its relevance to New Zealand and the TWG's work.

The TWG held a one-day conference to discuss tax reform on December 1. The presentations are available at <http://www.victoria.ac.nz/sacl/cagtr/twg/programme-slides.aspx>. It also decided to produce this report, "*A tax system for New Zealand's future*". I am pleased that the Group chose to do this: it is

appropriate given the importance of this issue, and the effort, time and quality of work from all of the Group's members, those who attended its meetings and the experts and officials who provided the background papers that were the basis for discussion. This report tries to capture the key insights from the Group's deliberations. Our thinking has evolved during the process and I am sure it will continue to evolve. As Chair, I would like to thank all of those involved in the work of the Group during the past six months. I would also like to thank the Centre for Accounting, Governance and Taxation Research for facilitating the work of the Group.

It has also been heartening to see the public interest in tax policy. The discussions of the TWG were always about the real-world effects of the tax system – its impact on people and firms, and the role of tax in improving peoples' lives and the country's economic performance. I hope that outlook is maintained by those reading this report and in decisions concerning any policy response.

A handwritten signature in black ink, appearing to read 'Bob Buckle', is centered on the page. The signature is fluid and cursive, with a large initial 'B'.

Professor Bob Buckle, Chair, Tax Working Group.

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Summary

Scope of the Tax Working Group

The aims of the Tax Working Group (TWG) were to (i) identify concerns with the current taxation system, (ii) describe what a good tax system should be like, (iii) consider options for reform, and (iv) evaluate the pros and cons of these options. Due to New Zealand's current fiscal circumstances, we accepted the constraint to consider tax reform on a fiscally neutral basis, and primarily focused on revenue raising taxes. New Zealand's tax system is not working effectively and reform is necessary if the country is to have a fair tax system that minimises the costs of raising taxes, reduces barriers to productivity and growth and positions it well for future challenges. The current system is incoherent, unfair, lacks integrity, unduly discourages work participation and biases investment decisions.

There are three critical concerns with the present system:

- The structure of the tax system is inappropriate: New Zealand relies heavily on the taxes most harmful to growth – particularly corporate and personal taxes on capital income. There is a major hole in the tax base concerning the taxation of capital, which is manifest in high investment and low returns in the property market. Many people face a disincentive to work because the abatement of Working for Families tax credits creates very high effective marginal tax rates.
- The tax system lacks coherence, integrity and fairness: Differences in tax rates and the treatment of entities provide opportunities to divert income and reduce tax liability. This disparity means investment decisions can be about minimising tax rather than the best business investment. For individuals, the tax burden is disproportionately borne by PAYE taxpayers since many with wealth can restructure their affairs through trusts and companies to shelter income from taxes or to enable people to receive social support.
- There are significant risks to the sustainability of the tax revenue base: Compliance is likely to be affected by perceptions that the system is unfair. International competition for capital and labour, especially from Australia, will impact on the sustainability of corporate and personal tax rates. Demographic change, together with the rising cost of financing higher public debt, will place higher demands on the tax revenue base while simultaneously placing greater tax pressure on a smaller proportion of the population.

Principles for Reform

Tax policy changes should be made with reference to a long-term strategy and framework that recognises the coherence of the overall tax system is vital.

The TWG considered options for reform in terms of six principles of a good tax system: the overall coherence of the system; efficiency and growth; equity and fairness; revenue integrity; fiscal cost; and compliance and administration costs.

A good tax system should also reduce uncertainty over future tax rates and the future application of tax bases. To achieve this it must be, and be seen to be, both economically and politically sustainable. To be economically sustainable, New Zealand's tax base will need to be less reliant on internationally mobile factors such as the incomes of capital and skilled labour. Political sustainability requires the tax system be robust against interest group pressure and political temptation to change the critical elements of a coherent system.

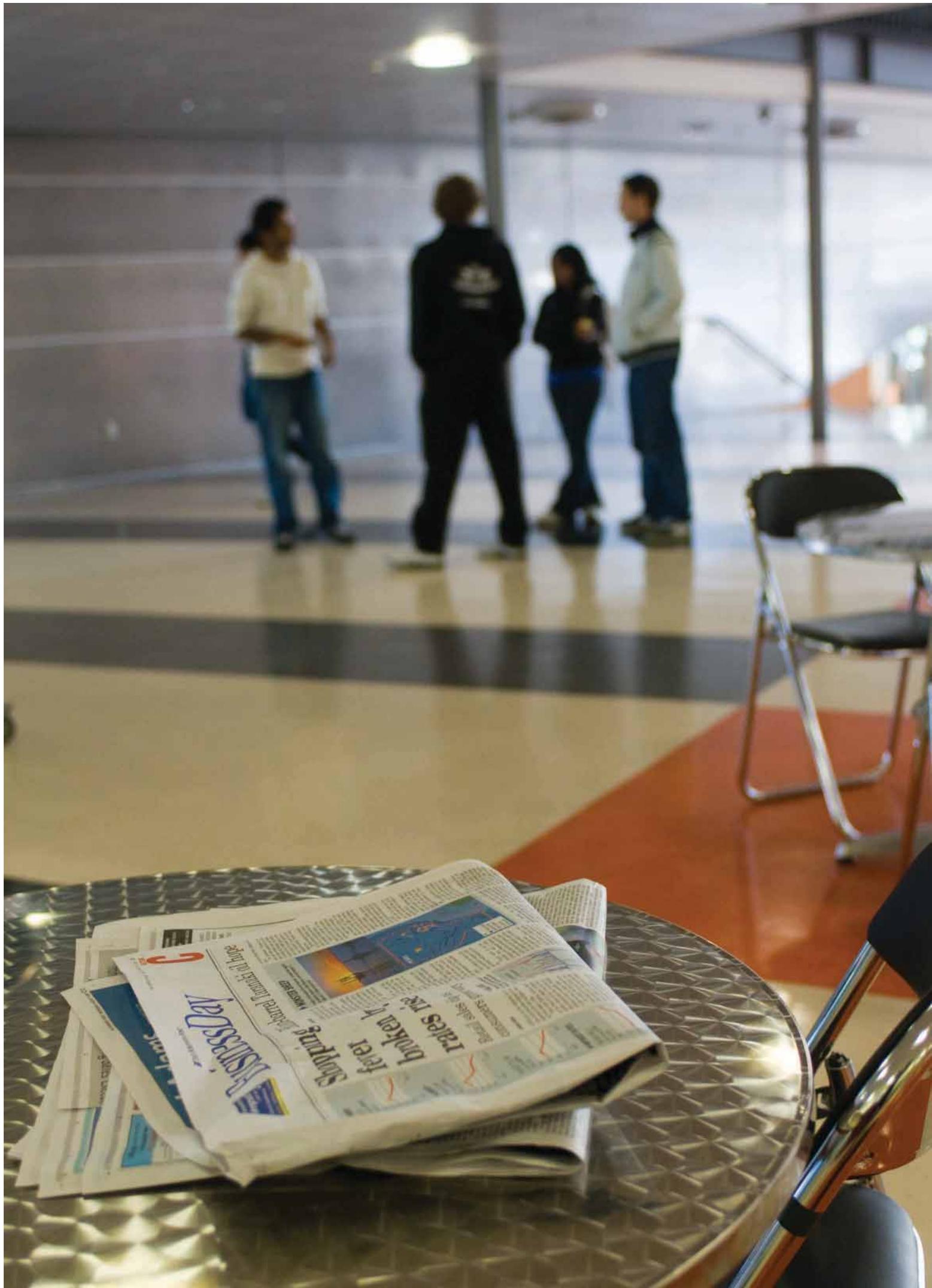
The TWG considers that the broad-base low-rate option is generally a sound principle to adopt in choosing the approach to tax design and should continue to be an underlying framework for the New Zealand tax system. Nevertheless, the approach of taxing those tax bases that are least likely to be subject to significant behavioural change from the imposition of a tax ('inelastic' bases) is also a sound principle to adopt when choosing between alternative tax bases to facilitate broadening the tax base and lowering rates. This approach can be consistent with the principle of broad-base low-rate if the tax base is sufficiently broad.

Recommendations

The TWG believes the problems with the current tax system are such that it requires significant change. The structure of the tax system needs to be significantly improved by making changes that involve a combination of changes to the tax bases and tax mix, to tax rates, and by improving some of the supporting tax rules. The main recommendations of the Group are:

- 1 The company, top personal and trust tax rates should be aligned to improve the system's integrity. If at any time this is no longer feasible due, for example, to global pressure causing the company rate to reduce, at the very least the trustee rate, top personal tax rate and top rate for portfolio investment entities (PIEs) and other widely-held savings vehicles need to be aligned, accompanied by the introduction of suitable fiscal integrity measures.
- 2 New Zealand's company tax rate needs to be competitive with other countries' company tax rates, particularly that in Australia. Balancing this factor against the integrity benefits of a fully aligned system will guide choices between an aligned and non-aligned system.
- 3 The imputation system should be retained. However, this may need to be reviewed if Australia decides to move away from its imputation system.
- 4 The top personal tax rates of 38% and 33% should be reduced as part of an alignment strategy and to better position the tax system for growth. Where possible, the Group would like to see a reduction in personal tax rates across-the-board to ensure lower rates of tax on labour more generally. This could be achieved as part of a package to compensate for any increase in GST.
- 5 Base-broadening is required to address some of the existing biases in the tax system and to improve its efficiency and sustainability. Base-broadening is also required if there are to be reductions in corporate and personal tax rates while maintaining tax revenue levels.

- 6 The most comprehensive option for base-broadening with respect to the taxation of capital is to introduce a comprehensive capital gains tax (CGT). While some view this as a viable option for base-broadening, most members of the TWG have significant concerns over the practical challenges arising from a comprehensive CGT and the potential distortions and other efficiency implications that may arise from a partial CGT.
- 7 The other approach to base broadening is to identify gaps in the current system where income, in the broadest sense, is being derived and systematically under-taxed (such as returns from residential rental properties) and apply a more targeted approach. The majority of the TWG support detailed consideration of taxing returns from capital invested in residential rental properties on the basis of a deemed notional return calculated using a risk-free rate.
- 8 Most members of the TWG support the introduction of a low-rate land tax as a means of funding other tax rate reductions.
- 9 The following targeted options for base-broadening should be considered for introduction relatively quickly:
 - Removing the 20% depreciation loading on new plant and equipment.
 - Removing tax depreciation on buildings (or certain categories of buildings) if empirical evidence shows that they do not depreciate in value.
 - Changing the thin capitalisation rules by lowering the safe harbour threshold to 60% or by reviewing the base for calculating this measure.
- 10 GST should continue to apply broadly. There should be no exemptions.
- 11 Most members of the Group consider that increasing the GST rate to 15% would have merit on efficiency grounds because it would result in reducing the taxation bias against saving and investment. However, any increase in the GST rate would need to be accompanied by compensation to those on lower incomes. This would significantly reduce the net revenue raised from a higher GST.
- 12 There should be a comprehensive review of welfare policy and how it interacts with the tax system, with an objective being to reduce high effective marginal tax rates.
- 13 Government should introduce institutional arrangements to ensure there is a stronger focus on achieving and sustaining efficiency, fairness, coherence and integrity of the tax system when tax changes are proposed.



Chapter 1: A World-Class Tax System: the Approach of the Tax Working Group

1.1 The need for change

For New Zealand to have a world-class tax system and to ensure that the system is sustainable in the future, significant change is required. Retaining the current tax system is not an option. The current system allows the set of statutory marginal tax rates that individuals face to be avoided easily in ways that are inefficient, unfair and add to business uncertainty. Over time, this is likely to erode the levels of voluntary compliance required to make a tax system work effectively. The Tax Working Group's (TWG) view is that improvements are required to make the system fairer, to reduce distortions and to be less damaging for economic growth, and to improve the coherence, integrity and revenue sustainability of the tax system. These objectives are unlikely to be achieved simply by small changes to the rates or thresholds of the current system.

This report sets out why the TWG has come to this view, and sets out options for change. This chapter provides an overview of the role of taxes, the principles of a good taxation system, issues with the current system, and the way in which the Group looked at options for change.

Chapter 2 examines the current tax system and explains in more detail our concerns with the current system; Chapter 3 looks at various tax types, their possible role in reform and options for a better tax system. Chapter 4 provides conclusions from the Group's work.

1.2 The role of taxes

Tax is necessary to fund government services and spending. But taxes also impose a cost. The obvious, or direct, burden of tax is simply the amount of tax paid. Taxes also, however, have a cost over and above the cost of the tax revenue raised. This is sometimes referred to as a deadweight cost or excess burden. This deadweight cost arises because of the way that taxes affect how people act (a tax bias cost) and because of the costs to taxpayers in complying with the tax and to the government in administering the tax.¹

Income taxes, for example, lower the reward from working. They provide a disincentive to work and incentives for people to avoid the tax: such as by working fewer hours, being paid 'under-the-table', or earning income from other sources. Any tax is inefficient to the extent that it biases people into acting in ways which would not be preferred in the absence of tax. Tax biases can also reduce the level of GDP.

In broad terms there are two types of taxes:

- *revenue taxes*, those that are about raising revenue (for example income taxes and GST) to fund government spending on things like health and welfare; and
- *corrective taxes*, those that are specifically designed to promote or discourage behaviours or to address the perceived costs of some activities.

The TWG has focused on revenue-raising taxes, which make up by far the greatest proportion of New Zealand's taxes, and how to raise revenue to fund government spending as fairly and efficiently as possible. There may be circumstances where corrective taxes are warranted to address externalities, such as pollution. The Group did consider some of the main areas where corrective taxes are used in some countries, such as environmental and excise taxes. However, these issues fall outside the scope of this review.

Box 1: New Zealand's tax system

Total tax revenue is the product of what is taxed (the tax base) and the rate at which taxes are levied on that base. New Zealand's main taxes are:²

	Tax revenue in 2009	% of total tax revenue
Personal income tax, levied using a progressive rate structure from 12.5% up to 38%	\$28.5 billion	53%
Company tax, levied at a flat rate of 30%	\$9.3 billion	17%
GST, levied at 12.5% on virtually all domestic consumption.	\$11.6 billion	21%
A range of excises on petroleum, tobacco and alcoholic products, some tariffs on imports, road-user charges and stamp duties.	\$4.8 billion	9%

The ideal tax system would be efficient (meaning that it would not distort people's behaviours) and provide the necessary revenue to finance the Government's spending at the least cost. It would also raise revenue in a way that people agree is fair. In practice, there can often be tradeoffs between fairness and efficiency. The tax base also needs to be sustainable over time. This is particularly important in a more globalised world (where taxing labour and capital income may be more difficult) and with population ageing (which may increase the need for robust tax bases). Another essential element of design, and sustainability, is choosing a tax system that is less vulnerable to interest group pressure and political temptation to change, and does not encourage avoidance.

To minimise inefficiency effects, economic theory argues that if the information is available, tax should be levied on those tax bases where there is least likely to be any behavioural change from the imposition of a tax – what are termed 'inelastic' (or unresponsive) bases.³ In the absence of perfect information, however, it is difficult to reliably identify and target the most inelastic bases of tax, and there can also be associated equity issues (for example, whether it is fair to tax some areas and where that tax burden falls).⁴ For these reasons, the approach in New Zealand over the last twenty years has tended towards a broad-base low-rate approach.

A broad-base low-rate (BBLR) system of taxation involves lowering tax rates and widening tax bases to try to avoid creating tax preferred investments or income sources. The aim is to reduce the cost of tax on any particular source and to minimise the behavioural changes caused by tax, and thus to reduce the economic harm of raising revenue. In general, as tax rates increase, the costs associated with imposing the tax worsen more than proportionately. If tax rates double, it is estimated that the costs associated with imposing a particular tax will approximately quadruple.⁵ This obviously means that high rates of tax create concerns. It also means that there are greater than proportional economic gains

from reducing high tax rates. The broad-base low-rate approach to taxation has other benefits such as administrative simplicity, and reduced opportunity for tax avoidance and arbitrage.

The shift to the broad-base low-rate approach can be seen in the removal of exemptions and lowering of rates in the personal income tax base in the late 1980s; and in the introduction of a low rate and comprehensive GST together with the removal of specialised and high-rate sales taxes.⁶ From a cost-of-tax perspective, New Zealand's broad-based GST, which has very few exemptions and a relatively low rate, is highly efficient. International studies have concluded that increasing rates of GST or property taxes are likely to be more efficient than increasing company tax rates or personal taxes.⁷ But in New Zealand, there is an additional reason that increasing GST is likely to have lower economic costs than a rise in income tax. This is because of our relatively broad and efficient GST base.

Box 2: Principles of a good taxation system

All of the options for reform were assessed as far as possible against six principles the TWG considered important for a sound tax system:

- 1 Efficiency and growth:** Taxes should be efficient and minimise as far as possible impediments to economic growth. That is, the tax system should avoid unnecessarily distorting the use of resources (e.g. causing biases toward one form of investment versus another) and imposing heavy costs on individuals and firms. An important question is how various taxes affect key economic and social variables such as employment, investment, savings, productivity growth and international competitiveness.
- 2 Equity and fairness:** The tax system should be fair. The burden of taxes differs across individuals and businesses depending on which bases and rates are adopted. Assessment of both vertical equity (the relative position of those on different income levels or in different circumstances) and horizontal equity (the consistent treatment of those at similar income levels, or similar circumstances) is important. The timeframe is also important, including how equity compares over peoples' life-times.
- 3 Revenue integrity:** The tax system should be sustainable over time, minimise opportunities for tax avoidance and arbitrage, and provide a sustainable revenue base for government.
- 4 Fiscal cost:** Tax reforms need to be affordable given fiscal constraints.
- 5 Compliance and administration cost:** The tax system should be as simple and low cost as possible for taxpayers to comply with and for the Inland Revenue Department to administer.
- 6 Coherence:** Individual reform options should make sense in the context of the entire tax system. While a particular measure may seem sensible when viewed in isolation, implementing the proposal may not be desirable given the tax system as a whole.

These principles are used in Chapter 3, which sets out the key features of various individual taxes and their possible role in reform.

There are areas in which New Zealand's tax base is not as broad as in other countries. An example is the absence of a comprehensive capital gains tax (CGT) across all types of income. This means that New Zealand has a lower tax on capital gains, including gains on property, than most other OECD countries. By not comprehensively taxing capital gains, New Zealand is unusual amongst OECD countries.⁸ One of the questions the TWG has addressed is whether or not the absence of a comprehensive CGT is a disadvantage. The Group also examined whether or not other forms of base

broadening, including taxes on land and property, might be desirable. The benefits from ownership of property and other forms of capital are not as comprehensively taxed as income and consumption and expanding the tax base in this direction may also have lower economic costs than a rise in income tax.

The TWG considers that the broad-base low-rate option is generally a sound principle to adopt in choosing the approach to tax design and should continue to be an underlying framework for the New Zealand tax system. It is also the trend in other developed countries, where, for the most part, there has been a move towards lower tax rates and wider tax bases.⁹

Nevertheless, the approach of taxing those tax bases that are least likely to be subject to significant behavioural change from the imposition of a tax ('inelastic' bases) is also a sound principle to adopt when choosing options to facilitate broadening the tax base and lowering rates. This approach can be consistent with the principle of broad-base low-rate if the tax base is sufficiently broad. When considering questions about the desirability of taxes on personal and company income, consumption and land and other property taxes, the TWG was therefore also concerned to ensure these questions were informed by information about the responsiveness of alternative tax bases and whether or not we are likely to be able to make the tax system more efficient by changing the tax mix and broadening the base.

Similarly, the effect of changes in the tax structure on equity is an important consideration. The TWG has attempted, where possible, to estimate the distributional effects of tax change options. But this is not straightforward. The appropriate information on the distribution of the liability for paying various types of taxes is not always available. Furthermore, taxes are not always borne by those that are liable to pay the taxes. Generally taxes will be shifted to some extent and often in ways that are difficult to determine. For example, income taxes on workers may to some extent be shifted forward into higher wage costs of firms. Additional taxes on rental housing to some extent may lead to increases in rents and so, in part, fall on tenants. As a result, our discussions on the incidence and distributional effects of taxes need to be treated with a good degree of caution because of the uncertainties concerning the extent of tax shifting.

1.3 Problems with the current system

In 1989, New Zealand's tax system was regarded as one of the least distortionary in the OECD and our tax rates were internationally competitive.¹⁰ A variety of changes to tax settings in New Zealand, and increasing globalisation and international tax trends have undermined this position.

Through the late 1980s reforms lowered personal and company tax rates, removed tax preferences for various sorts of activity like exports, eliminated taxes such as stamp and estate duties and widened the tax base, most notably through the introduction of a single consumption tax, GST, that replaced sales taxes.¹¹ These changes improved the efficiency and equity of the tax system relative to the comparatively narrow-based, high-rate system that preceded it.

The broad impetus behind these reforms continued into the 1990s, where our personal income, corporate income, and GST designs continued to reflect the broad-base low-rate approach. A major feature of the tax system was our full imputation company tax system combined with the alignment of the corporate, trustee and top personal rates of tax at 33%.

More recently there have been a number of changes made to the tax system that have eroded its effectiveness. Individual policy changes were made for a variety of reasons, including the intention to improve efficiency and equity. But in the process, the top personal, corporate and trust rates of tax became misaligned. The changes have also accentuated the consequences of an absence of some tax bases and, overall, this has given rise to integrity, efficiency and fairness concerns.

Different forms of income are taxed in different ways and at different rates and there has been a substantial shift of income from individuals (taxed at a top rate of 38%) into trusts (where there is a top rate of 33%).¹² There is also, for example, a very large investment in rental properties, where overall this \$200 billion sector of the economy had a negative taxable return of about \$500 million in 2008.¹³ By comparison, the New Zealand Stock Exchange has a market capitalisation of about \$55 billion. There has also been a growing incoherence in the tax rates applying to portfolio investment entities (PIEs) and other savings entities relative to those imposed on income earned by individuals. As a consequence of these piece-meal changes, the comprehensive income tax base has been eroded and complexity of the system has increased. These problems are accentuated by the inconsistent tax treatment of property. The TWG considers it is essential these inconsistencies be rectified.

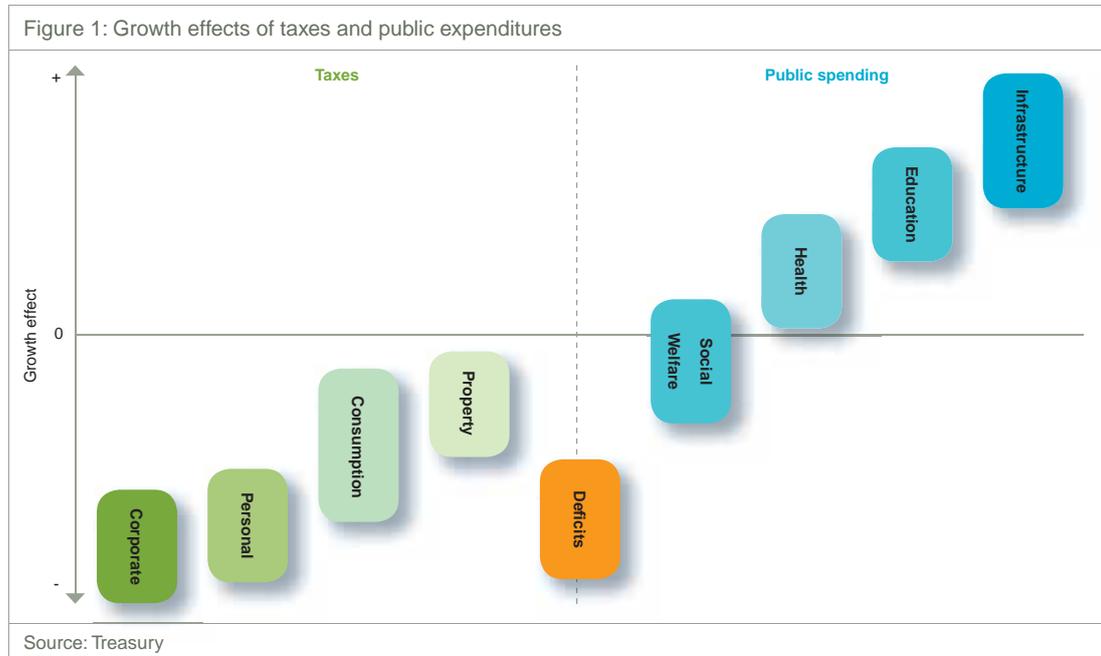
The introduction of Working for Families (WfF) also had important implications for the tax system. Working for Families has given assistance to low income families, but it has changed the interface between transfers and income taxes. The way WfF provides income support through tax credits means that some recipients of WfF benefits have negative average tax rates (i.e. they receive more back from WfF than they pay in tax). At the same time, however, it increases the effective marginal tax rate (the tax on any extra dollar earned) for many taxpayers. These effects can arise from many forms of social welfare support, particularly if they abate with income.

In effect, Working for Families means that households (with children) in the bottom half of the income distribution effectively pay no income tax or receive tax credits, and that most income tax is paid by those people not receiving WfF. The top 10% of income earners now pay 44% of all personal income tax (if the impact of WfF, New Zealand Superannuation and other benefits including the unemployment benefit are included, the top 10% of taxpayers now pay 76% of net tax). Furthermore, fiscal drag (a situation where rising incomes push people into paying higher tax rates over time if there is no change to tax thresholds) means that about 9% of income earners are now paying the top tax rate (compared to about 5% in 2000). Fiscal drag also means that New Zealand's revenue base will be increasingly reliant on personal taxes and these taxes, along with corporate taxes, are the most damaging for growth.

Along with shifts in domestic policy, the changing international environment is putting pressure on the tax system. In 1989, New Zealand's 33% corporate tax rate was one of the lowest in the world. That situation has changed markedly in the last 15 years. While New Zealand's corporate rate has been reduced to 30%, the average rate for small OECD countries is now 26%.¹⁴

This situation represents an important challenge for the design of the New Zealand tax system. Increasing global competition for labour and capital has meant that these tax bases are becoming more 'elastic'. Increasing globalisation has also meant that international personal income tax rates

and corporate tax rates have been falling and may fall further. Seventy percent of New Zealand's tax revenue is from personal and company taxes and our reliance on these more mobile tax bases – business, capital and people can all move across national boundaries – makes us increasingly vulnerable to international competition, and may threaten New Zealand's productive potential and future living standards.



Numerous recent studies suggest that, while almost all taxes impact adversely on growth to some degree, some taxes have larger impacts than others.¹⁵ Figure 1 provides a schematic summary of these results. Each 'block' represents the range of estimates for the growth impact of a particular type of tax (personal income, corporate, etc), public expenditure or deficit. Where blocks overlap this indicates that the ranges of estimated growth impacts for these taxes overlap. Figure 1 indicates that personal income and corporate taxes tend to be the most growth-reducing while consumption and property taxes tend to be least growth-reducing taxes. This may reflect the level of the relevant tax rates and the structure of those taxes in practice (e.g. extent of tax exemptions, progressivity of rates, etc). Large deficits can also be harmful, in part because high government borrowing can crowd out private investment.

Demographic changes, particularly population ageing over the next 20 years, will also impact on the sustainability of government expenditure and tax revenues. The recent Long-term Fiscal Statement produced by the Treasury shows that the ratio of those over 65 years of age to those aged between 15 and 64 (who are defined as "working age") more than doubles by the year 2050 and spending on superannuation and health is projected to increase markedly.¹⁶ To maintain existing levels of services, the tax base will need to maintain or increase revenues; and there will need to be consideration of alternative bases of taxation, and of ways to make the tax base less reliant on taxes that are ultimately sourced from benefit and superannuation payments.

1.4 A future tax system for New Zealand

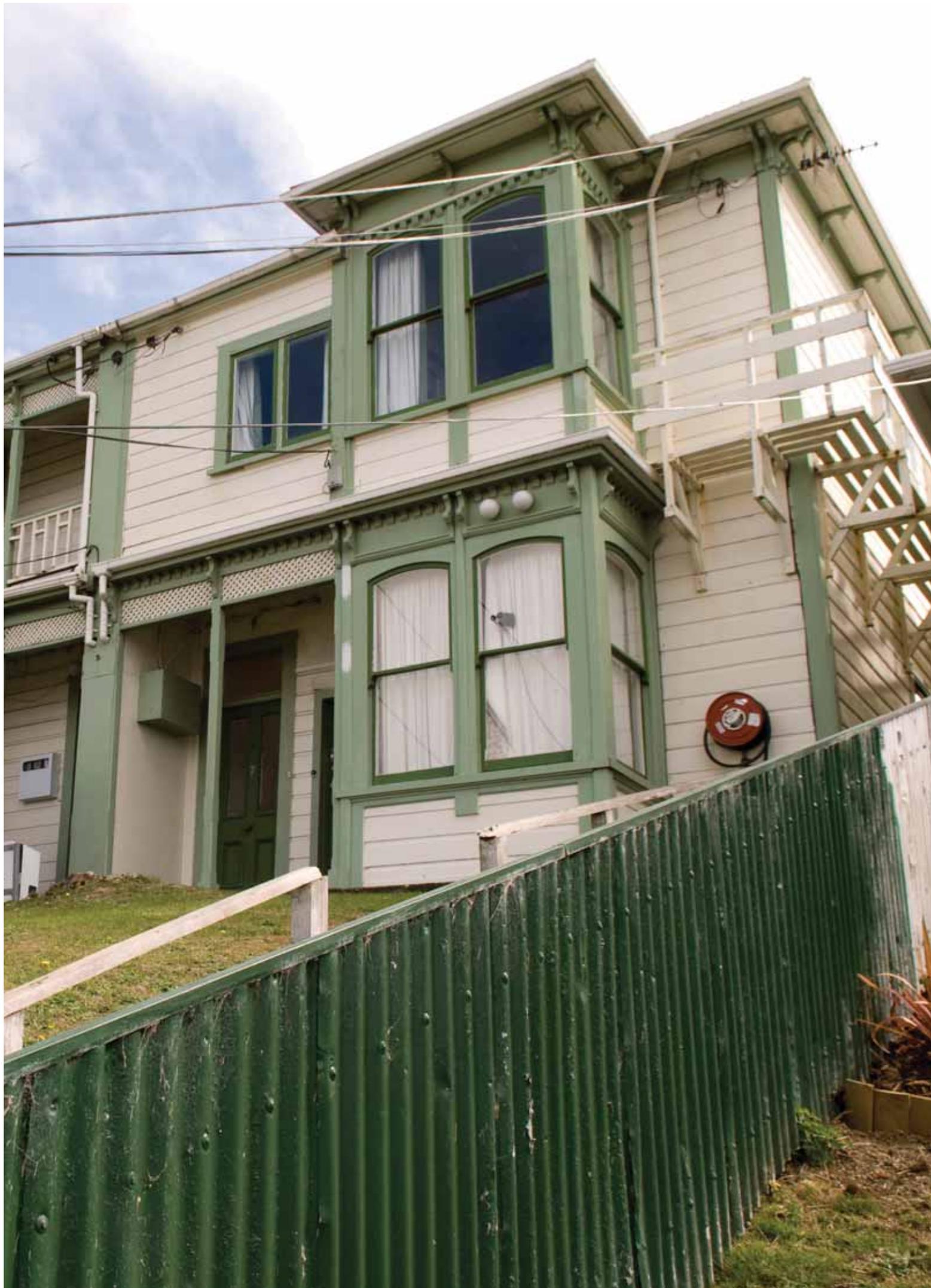
The key challenge for New Zealand's tax system is to deliver revenue to governments in a manner that is less damaging to the country's growth prospects, is fairer and is drawn from tax bases that are sustainable into the future. It was against this background, and the necessity, given the fiscal outlook, to ensure that any tax reform was revenue-neutral, that the TWG considered options for New Zealand's medium-term tax system.

One set of options considers the alignment of the corporate, trustee and top personal tax rates. The lower the rate at which alignment is set, the greater the extent that base broadening is required to fund lost revenue. The reform options put forward by the Group also recognise that it may not be feasible to maintain alignment as New Zealand's corporate tax rate cannot be set completely independently of other countries' rates – in particular, that in Australia. Governments may feel they need to reduce corporate rates further than they are prepared to reduce personal tax rates. The TWG therefore explored non-aligned options.

Any of these non-aligned options will introduce additional complexity to the tax system. As set out in Chapter 2, recent experience has demonstrated that a gap in tax rates has, under the current New Zealand tax system, provided strong incentives for behavioural change and created integrity and efficiency issues. Therefore, a non-aligned system would require measures to support the integrity of the tax system. The greater the non-alignment of tax rates, the more complex the problem. Nevertheless, non-aligned systems are common internationally.

The TWG believes that base-broadening measures, such as a more coherent taxation of the gains on capital or possibly a land tax, are important in themselves and not just for raising the extra revenue required to finance other changes to the system. New tax bases are necessary to ensure that there really is a "broad base" to the system to improve integrity and efficiency and to improve equity and fairness of the tax system. A broader base can also provide a more sustainable tax revenue base. The current ad hoc taxation of capital, for example, means there are currently areas with zero tax rates that distort investment and behaviour, and undermine both fairness between taxpayers and the system's integrity. And as discussed earlier, a broad base means there can be lower tax rates across other parts of the system (and therefore generally lower economic costs).

Most importantly, the TWG believes that for New Zealand to have a world-class tax system and to ensure that the system is sustainable in the medium-term, significant changes are required to the current tax mix and base. Small changes at the margin are unlikely to achieve this.



Chapter 2: Concerns with the Current Tax System

In 1989, New Zealand's tax system was regarded as one of the least distortionary in the OECD.¹⁷ Its tax rates were comparatively low: the corporate and top personal tax rates were 33%, well below the OECD average; and New Zealand's GST of 12.5% was seen as the best tax of its type internationally. In 2009 the tax system cannot be described as world class. Various developments, both within New Zealand and internationally, call into question whether or not our current tax settings are right, and the continuing viability of the current system.¹⁸

The TWG considers that government will need to make crucial decisions about the overall structure of New Zealand's tax system – the bases that it chooses to tax and the rates at which it taxes them – and how to deal with some critical integrity concerns and a lack of coherence that have emerged over recent years. This is because the current system is not designed to minimise adverse effects on economic growth. While BBLR is a sound principle for the tax system, it is also appropriate to recognise that taxes on some bases are more damaging for growth. The tax base is also seriously undermined because of the system's lack of integrity, and this has significant adverse effects on fairness. Without change, these issues will get worse.

An effective tax system has a high degree of public acceptance and compliance. If the system is perceived to be ineffective and unfair, something that this process has identified, then this will raise questions for people about where the tax burden falls and why they should comply.

2.1 Problems with the structure of the New Zealand tax system

There are four major issues with the structure of the tax system:

- A lot of revenue is raised from the taxes most harmful to growth and this adversely impacts on savings, investment and productivity.
- Our personal and corporate tax rates are becoming less internationally competitive, which leaves our tax base vulnerable as a result of labour and capital being increasingly mobile.
- Working for Families has introduced very high effective marginal tax rates (often well above 50%) for thousands of workers.
- There is a major hole in the tax base for the taxation of capital, which is manifest, for example, in high investment and low taxable returns in the property market.

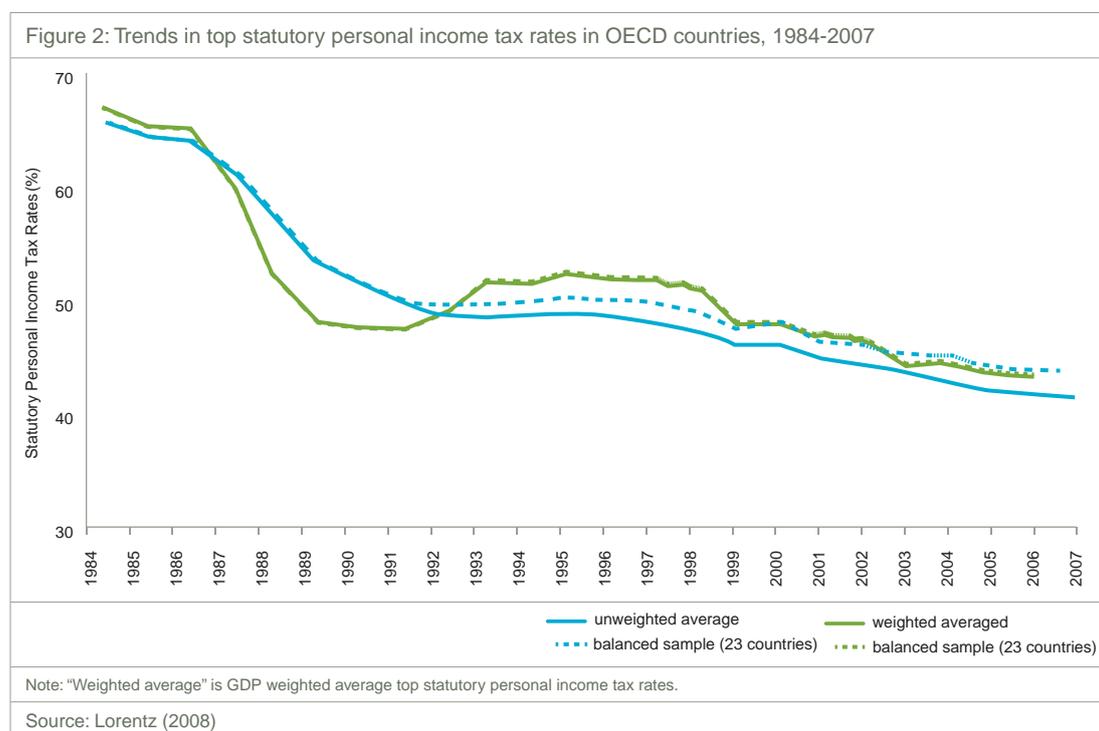
Growth distorting taxes

All countries have to choose which bases – for example personal income, corporate profits, wealth, or consumption – to tax. These choices are typically motivated by wanting to raise revenue equitably while minimising the adverse impacts on economic efficiency and compliance that all taxes, to some extent, create.

A major efficiency concern with the current structure of the New Zealand tax system is the impact that personal and corporate taxes have on productivity and GDP growth. International evidence suggests that these two taxes are among those taxes which are most harmful to growth. On the other hand, taxes on consumption and annual property taxes such as rates, are among those taxes which are the least harmful to economic growth.¹⁹

Personal tax rates becoming less competitive

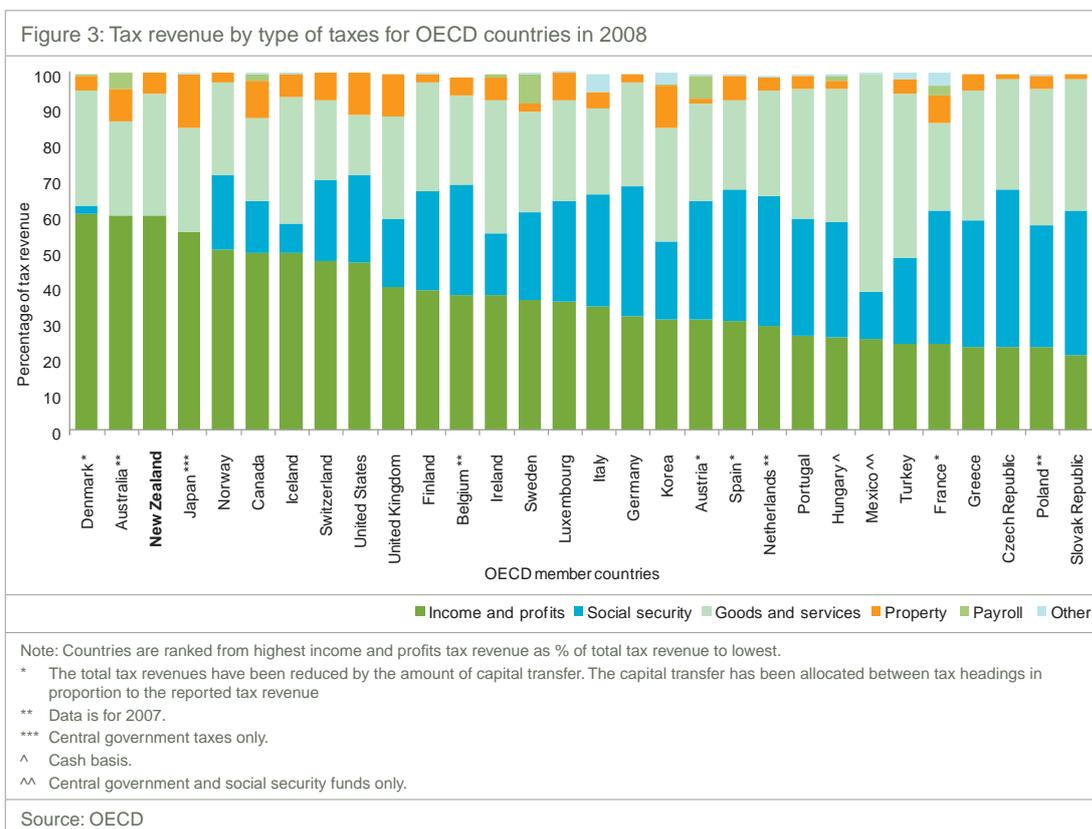
In the late 1980s New Zealand was ahead of international trends in getting the rates of personal and corporate taxes down and switching to a broad-based consumption tax (GST). Since 1989, New Zealand's tax rates have remained fairly static (although the top personal tax rate was raised significantly in 2000), while both personal and company tax rates have been falling internationally. Internationally, personal income tax rates have been falling steadily for the past 30 years and there has been a tendency for countries to flatten personal taxation structures. Figure 2 reveals this clear pattern for the OECD between 1984 and 2007.²⁰ The OECD average top personal tax rate declined from 46.5% to 42.5% between 2000 and 2007 and has declined further to 41.9% in 2008, while in New Zealand this top personal tax rate remained the same in that period (after it was increased to 39% in 2000). A similar pattern is evident for other non-OECD countries in that period. For lower income countries the average top personal tax rates are even below those that prevail on average in the OECD, and in many countries they are significantly lower than New Zealand's top personal tax rate.²¹



The current New Zealand top personal rate at 38% is not especially high by OECD standards, but even at 38% it is calculated to have significant adverse efficiency costs, exacerbated by the fact that it starts at a lower income level than most countries' top rate. These efficiency costs include the fact that higher tax rates distort people's behaviour compared to their preferred choices when there is no tax. This happens in numerous ways including in hours worked, jobs undertaken, methods of saving, and

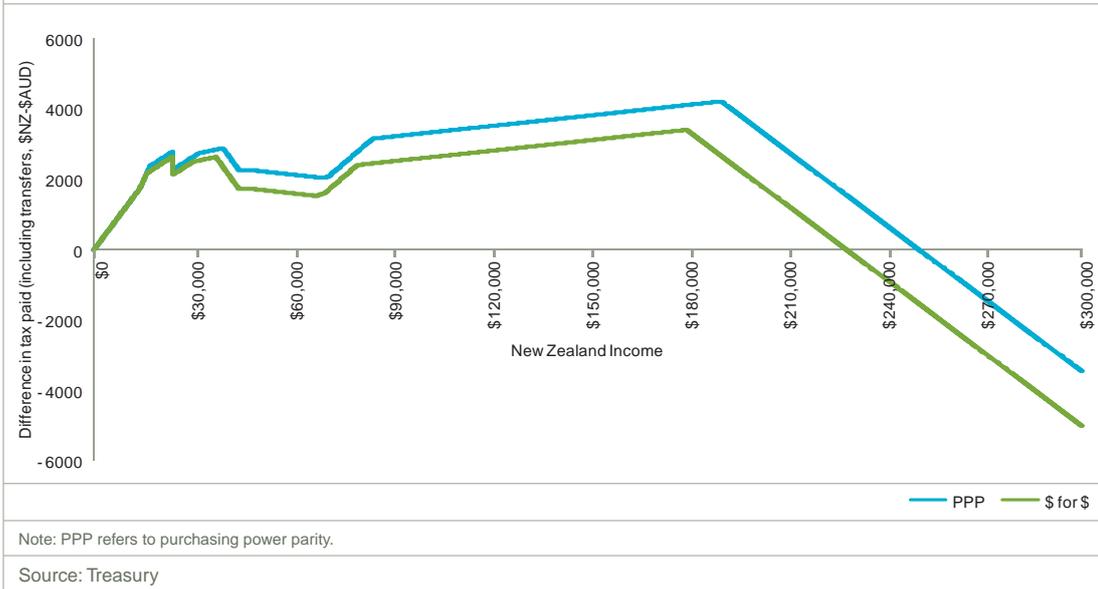
choices over investment and tax avoidance. They also include the costs of collecting and complying with tax rules which mean that estimates of these 'deadweight costs' (which include administrative and compliance costs) are hard to calculate accurately. But estimates in the range of 20c to 70c per dollar of income tax revenue raised are quite plausible.²²

New Zealand is not out of line in terms of its reliance on personal and corporate taxes as a proportion of tax revenue collected.²³ However, it is important to consider the differences in the way the corporate, personal and social security taxes impact growth. This is because other countries have lower tax rates that apply to all forms of income (from labour, corporate profits, personal capital income such as interest earned, etc) and supplement this with social security contributions (SSCs) that are specific to labour income - wages and salaries – and that do not apply to the other forms of income (see Figure 3). New Zealand has no social security taxes. This means that New Zealand taxes personal capital income, such as interest received on bank deposits, higher than most other OECD countries, and so taxes savings more heavily. Economic growth is therefore adversely affected.



The high international mobility of our labour force, and especially the ease of migration and attractiveness of Australia to New Zealand workers, means it is important that our personal tax settings do not worsen an already substantial wage gap with Australia. Australia has reduced effective tax rates (by increasing thresholds or cutting rates) over the last decade. Consequently, differences in personal tax rates has meant that differences in the post-tax wage gap between New Zealand and Australia is greater than the pre-tax wage gap. Figure 4 shows that individuals in New Zealand earning less than \$240,000 per year will pay on average more income tax than those on equivalent salaries in Australia.²⁴

Figure 4: Comparison of taxes paid in New Zealand and Australia by salary and wage earners (single with no children)²⁵



Working for Families and high effective marginal tax rates

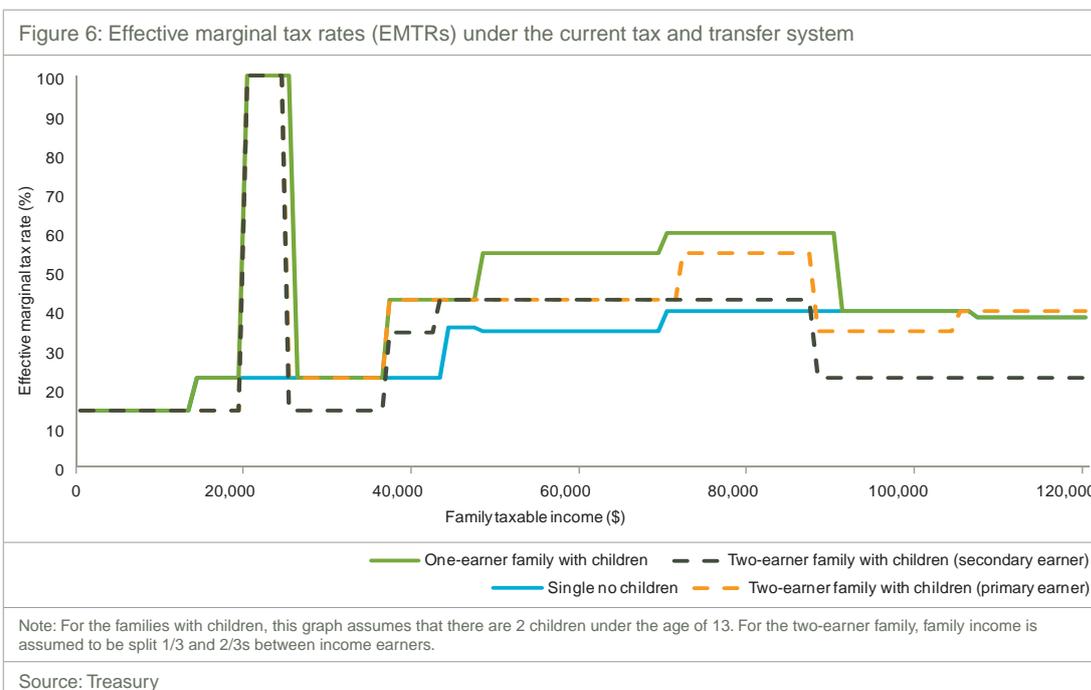
The introduction of the system of family tax credits, most recently through Working for Families, has also had important implications for the tax system. WfF provides valuable assistance to low income families, but it leads to two problems for the tax system. Working for Families means that over 40% of households pay no income tax or receive net transfers. This means that once WfF tax credits and other transfers are taken into account, a substantially higher burden falls on higher income households (see Figure 5).

Figure 5: Distribution of New Zealand's personal tax & transfers



The second concern is that WfF has resulted in significant increases in the effective marginal tax rate (EMTR - the tax paid on any extra dollar earned) for many taxpayers, because they lose benefit receipts as well as pay income tax when they earn extra income. Any family receiving WfF and with family

income above \$48,000 faces an effective marginal rate of 53% or 58% on the primary earner. For many secondary earners in these families the tax rate on any extra income is 41% or higher. Figure 6 shows the effective marginal tax rates currently faced by taxpayers in each income band. These are very high rates in absolute or relative international terms. Further marginal rate effects arise from other forms of social welfare support, particularly where they abate with income.



Taxation of capital income

New Zealand's high personal and company tax rates are in marked contrast to the taxation of capital. Unlike most other countries, New Zealand does not generally tax capital gains on property, unless the property investment was undertaken with the intention of realising capital gain income. As a result, taxpayers have realised substantial capital gains on residential property investment in recent years without incurring tax liability. This also means that when house prices fall the government is not vulnerable to large revenue losses. But to the extent that the real value of property rises over the longer term, there is a potential net revenue loss to the government by not taxing these capital gains.

In addition, like many other countries, New Zealand has retained a tax bias in favour of investment in owner occupied property by not taxing imputed rents (i.e. what people in owner-occupied homes would otherwise have to pay in rent). The tax system also biases investment in favour of rental property investment. One of the consequences has been that in recent years there has been a steady decline in taxable income declared by rental property investment and indeed, there have been substantial net tax revenue losses.²⁶

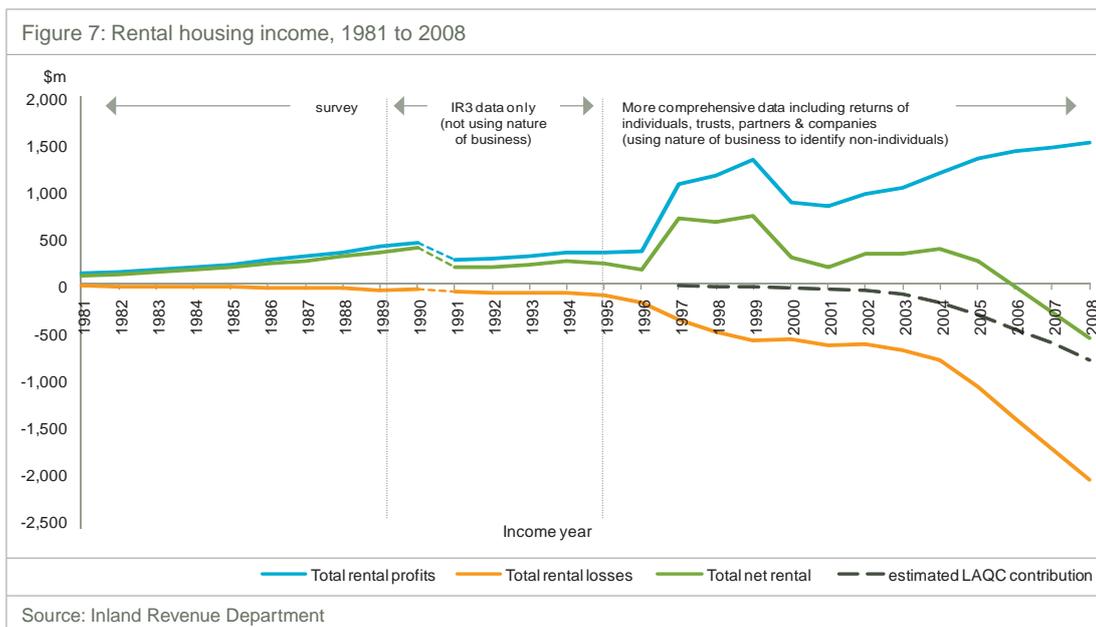
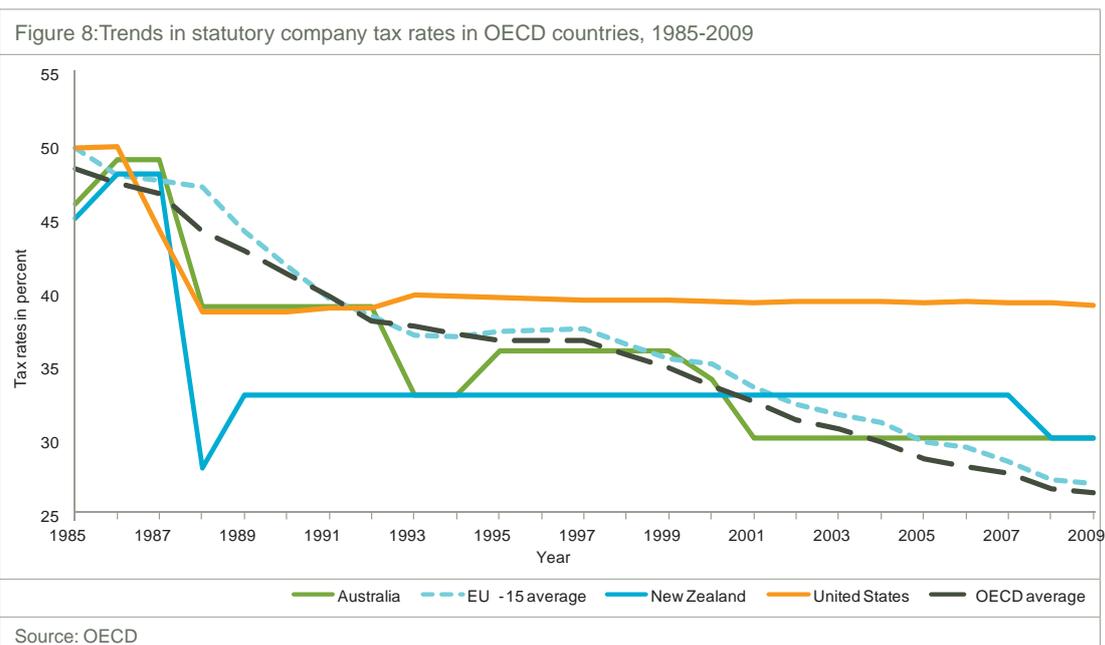


Figure 7 shows total rental profits, losses and net rental income since 1981. The figure reveals that there has been a marked decline in net rental income since 1999, a pattern accentuated by losses claimed by loss attributing qualifying companies (LAQCs). An LAQC is a normal company that has special tax status that enables losses to be offset against the shareholders' personal income for determining their tax liability. A consequence of the tax treatment of rental property investment is that the \$200 billion investment in rental housing generated net rental losses totalling about \$0.5 billion and approximately \$150 million in tax revenue losses in 2008.

In contrast with the treatment of capital gains and property, New Zealand taxes corporate taxable income at a relatively high rate. The changing international environment is putting pressure on the corporate tax system. In 1989, New Zealand's 33% corporate tax rate was one of the lowest in the world. That situation has changed markedly in the last 15 years (see Figure 8). While New Zealand's corporate rate was reduced recently to 30%, the average rate for small OECD countries is now 26%. International trends may not continue into the future at the same rate (for example, as a result of many countries experiencing huge increases in public deficits and debt following the global financial crisis). However, further reductions in company tax rates overseas will mean that New Zealand would be vulnerable and would be under pressure to reduce its company tax rate.



In a global economy, company tax can discourage inbound investment. For a small open economy that can import as much capital as it wishes at a fixed after-tax return, the tax will not be borne by foreign residents. Instead, it will reduce capital invested in the economy and adversely impact on labour productivity and real wages.

A relatively high company tax rate can encourage firms to relocate business functions outside of New Zealand and also encourage multinational firms to stream profits away from New Zealand and into lower tax countries. This streaming can be achieved by firms:

- “Thinly capitalising” their New Zealand operations (by financing as much of their New Zealand activities as possible by using debt rather than equity); or
- Using transfer pricing arrangements where New Zealand entities pay as high as possible prices and charge as low as possible prices on transactions with associated companies overseas.

There are measures to prevent transfer pricing and thin capitalisation but these are not completely effective. Incentives to stream profits from New Zealand overseas will tend to arise when the New Zealand company tax rate is higher than in other countries, or where those other countries have an imputation system, such as Australia.

The above factors support a reduction in the company tax rate. However, there are also a number of factors that suggest for New Zealand, a deep reduction in the company tax rate may not be the most efficient approach. A higher company tax rate ensures maximum taxation of economic rents (these are profits above the normal return earned on an investment). If foreign inbound investment in New Zealand generates location specific economic rents (i.e. extra profits arising from advantages foreign companies accrue from being located in New Zealand), then the main effect of taxing this income is to generate tax revenue allowing lower taxes to be imposed on New Zealanders.²⁷ However, a possible consequence of reducing the company tax rate is that to the extent this benefits non-residents, taxes levied on New Zealand residents would need to be higher.

The availability of foreign tax credits to non-resident shareholders is also an issue to be considered in setting the company tax rate. Where non-resident shareholders are able to receive a tax credit in their home country, there is no additional cost imposed by New Zealand company tax. As such, non-resident shareholders will not demand an additional return which would otherwise increase the cost of capital to New Zealand firms. Where a foreign tax credit is available, reducing New Zealand company tax only leads to a transfer of revenue from New Zealand to the overseas government's revenue. However, taxes paid by foreigners provide scope to reduce the tax burden on domestic residents.

Company tax also provides a backstop to the personal tax system in limiting the benefits of income being sheltered in companies to avoid personal income taxes. Income earned by a company is subject to company tax. This is, in effect, a withholding tax for domestic shareholders as the personal and company systems are integrated by the imputation system. As such, corporate income is subject to personal marginal tax rates when distributed to domestic shareholders.²⁸

In practice, determining the best rate of company tax for New Zealand means making judgements on the benefits and costs of cutting the company tax rate in the face of considerable uncertainty. What other countries do will also have an influence. For example, if other countries continue to cut their company tax rate, in particular, if Australia decides to have a significant cut in its rate, the question arises of whether or not it would be sensible for New Zealand to continue with its 30% company tax rate, which is already high by OECD standards.

2.2 A lack of coherence, integrity and fairness

There are five major issues with the coherence, integrity and fairness of the tax system:

- There are differences in the tax treatment of entities which provide the potential to divert income and reduce tax liabilities, and the opportunities to reduce taxes differ across income groups.
- The disparity in the tax treatment of entities distorts investment decisions and decision-making about the best commercial or business structure to apply.
- The policy intent of tax legislation is not always clear, and this creates uncertainty.
- Different entities (such as trusts and companies) can be used to shelter income from various social taxes (e.g. child support and student loan repayments) or to enable people to receive social support.
- These problems have been accentuated by the non-alignment of the top personal, corporate and trust tax rates.

The current tax structure provides opportunities for individuals to significantly alter their taxable income and the amount of tax that they pay. For example, out of an Inland Revenue sample of 100 of the highest wealth individuals in New Zealand, data indicate that only about half are paying the highest marginal tax rate on their income. These taxpayers are not necessarily doing anything wrong but are merely taking advantage of the opportunities offered by the current system to shelter income from higher rates. This calls into question the integrity and fairness of the system.

The current system allows taxpayers considerable freedom in the choice of entities through which they

conduct their affairs. For example, individuals can hold their investment assets directly, or the assets can be held indirectly by placing them in a company, a trust or a portfolio investment entity (PIE). A business can be operated as a sole trader or through a company or trust. A considerable range of tax rates apply to these different entities (see Table 1).

Table 1: Tax entities and tax rates

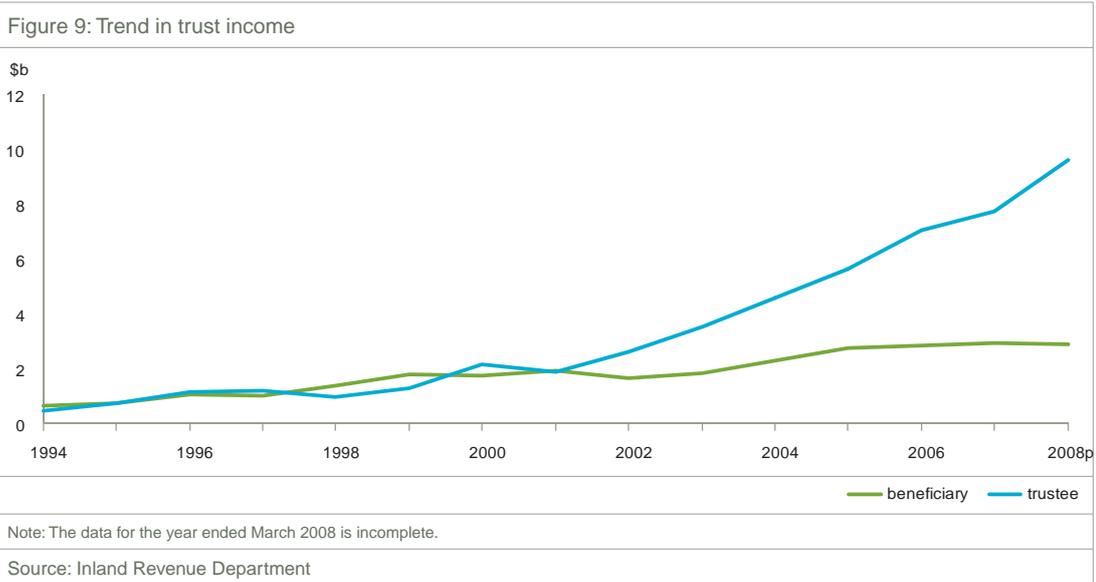
Investment entity	Marginal tax rate
Individual	0%-38% depending on level of taxable income.
Portfolio investment entity (PIE)	0%, 19.5% or 30%. ²⁹
Company	30%, then marginal personal income tax rate of shareholder (0%-38%) on payment of a dividend.
Trust	Trustee income - 33%. Beneficiary income - generally marginal tax rate of beneficiary (0%-38%).
Qualifying company/loss attributing qualifying company	30%. However, there may be claw-back on payment of dividend to high marginal tax rate recipient.
Partnerships	Marginal tax rate of each individual partner (0%-38%).
Superannuation funds	33% or 30% if widely held.

When New Zealand's imputation system was introduced in 1988, the company tax rate, the trustee tax rate and top personal tax rate were aligned at 33%. This meant that companies and trusts could not be used to shelter income from higher personal tax rates. It ensured that company and trust taxation performed a very important function in supporting the integrity of the personal tax system.

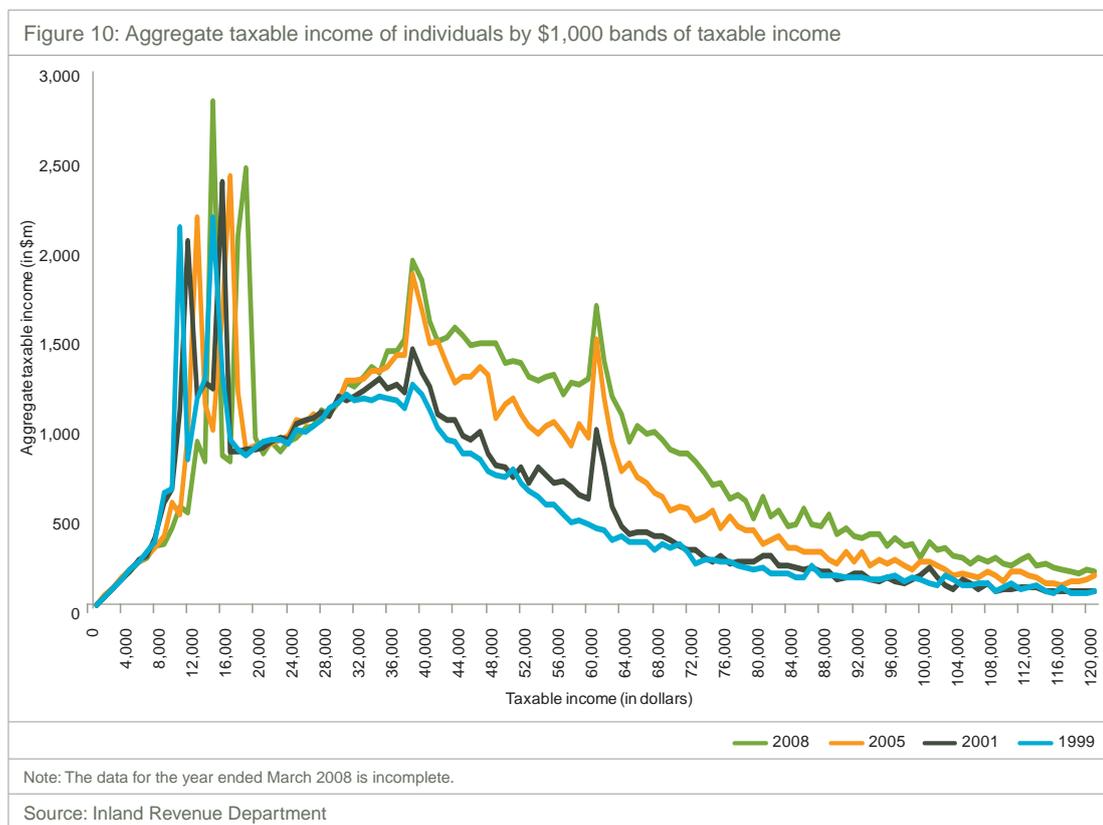
The rise in the top personal tax rate and lowering of the company tax rate has opened up a substantial gap between the company tax rate, the trustee rate and the top marginal tax rate. This diversity of tax rates means individuals can shelter personal income from higher effective marginal rates using companies, trusts, PIEs and other savings vehicles. Information derived from tax collection data since the introduction of the higher top rate indicates that there has been considerable rearrangement by taxpayers to minimise tax and avoid the full application of the intended progressivity of the tax system.

There are a number of ways of escaping higher marginal and effective marginal tax rates by diverting income to lower-taxed companies or trusts. For example, by earning income through a company, an individual can ensure that income is taxed at a 30% rate so long as profits are retained within the company. While income may eventually be taxed at the shareholder's marginal rate when dividends are paid, there can be substantial benefits from tax deferral if income is retained for a number of years in a company before it is distributed as dividends. In some cases the deferral can be permanent if the shareholders sell their shares at a tax-free capital gain.

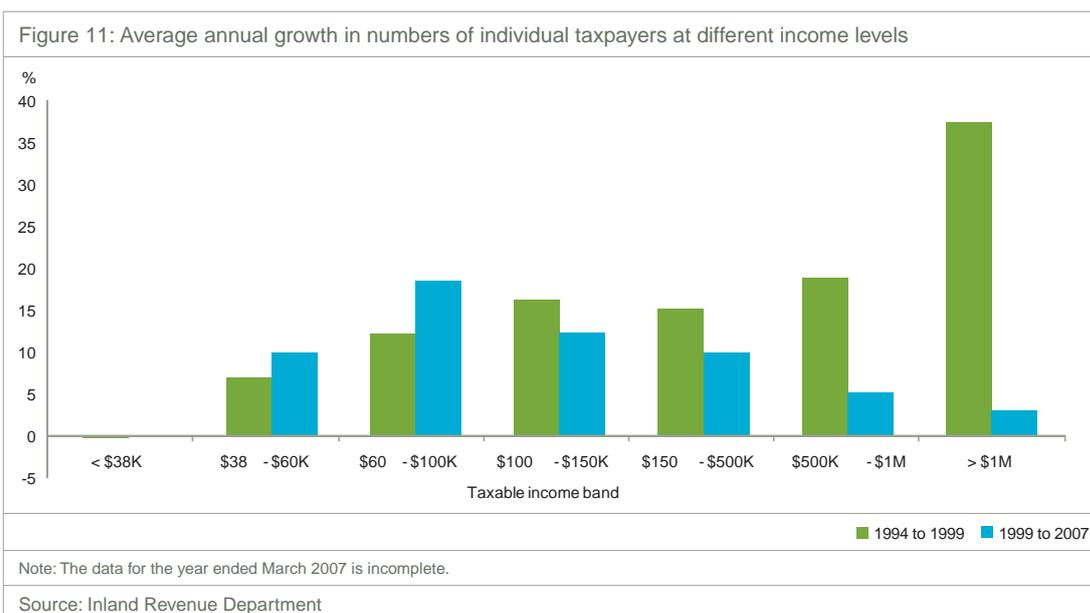
Trusts can be used to shelter income by having it taxed as trustee income (at a rate of 33%) rather than having it distributed to beneficiaries and taxed as their income. Unlike company tax, where there will eventually be a wash-up on distribution, the trustee tax is a final tax. There is continuing evidence of trustee income growing much more quickly than beneficiaries' income, which represents a significant fiscal cost (see Figure 9). The ability to shelter income in trusts cost the government roughly \$300 million in tax revenue in 2007.³⁰



The effect of these various strategies is illustrated in Figure 10, which shows aggregate income of individuals in different income bands for the years 1999, 2001, 2005 and 2008. In 1999, before the introduction of the 39% top marginal rate for incomes above \$60,000, there was no spike clustered at the \$60,000 threshold. Since then, an obvious spike has developed. For example, in 2007 much more income was attributable to people earning between \$59,000 and \$60,000 than for other \$1,000 bands of income on either side. This suggests that those who would otherwise be facing the top marginal rate may be using companies, trusts and other savings vehicles to shelter income from higher rates of personal tax.³¹



The impact of raising the top marginal tax rate has also been evident in the annual growth rates of taxpayers declaring taxable income in particular income bands. Over the period from 1999 to 2007 there has been very slow growth in the numbers of taxpayers on higher incomes compared to growth rates in earlier years, despite higher economic growth during this period (see Figure 11). Again, this seems likely to be evidence of greater income sheltering, undermining the integrity of the tax system. The sheltering raises concerns about whether it is fair for some taxpayers to be able to escape higher personal rates while others, such as salary and wage earners, face the top statutory tax rate. It also raises efficiency concerns.



The disparity in the tax treatment of entities distorts decision-making about the best commercial or business structure to use in any given situation, as some structures provide significant tax advantages over others. Taxpayers may choose inefficient models and incur financial structuring costs in order to take advantage of the different tax rates and rules applying to different business vehicles. These costs do not add to the productive capacity of the economy and can result in lower effective tax rates for more sophisticated investors.

Different entities can also be used to shelter income from various social taxes or to enable people to receive social support. For example, Working for Families tax credits abate with income. Student Loan and Child Support payments depend on income. If income is sheltered in companies, trusts or other entities, this will also affect a taxpayer's obligations in respect of these sorts of measures. The current tax system, which allows people to redefine their taxable income, means that the redistributive objectives underlying the current statutory personal tax rates and thresholds and other measures which also influence EMTRs are not being achieved.

The ease with which income can be diverted to reduce tax liabilities creates a very difficult issue: given the structural inconsistencies of legislation, what diversion is avoidance and hence able to be overturned by Inland Revenue, and what is acceptable utilisation of choices available to taxpayers to reduce

their tax liability? Attempting to police these difficult boundaries places considerable administrative strain on Inland Revenue's resources. The uncertainty imposes costs on taxpayers.

Box 3: Examples of behaviour to reduce tax or increase benefit entitlement:

- The use of a trading company owned by a trust. Income accumulating in trusts and distributions from trusts of amounts that have previously been taxed at 33% as trustee income are not counted as income for WfF purposes. This means that substantial receipts by beneficiaries of trusts are not taken into account in determining their WfF entitlements.
- Employees of closely-held companies who maximise fringe benefits instead of receiving taxable wages and salary. These fringe benefits can be close substitutes for cash - for example, the use of an employer's credit card and do not reduce an employee's WfF entitlement.
- Individuals investing in portfolio investment entities (PIEs) rather than a normal bank account because distributions from PIEs are not taken into account in determining WfF entitlement.
- 9,700 families with rental losses who receive WfF tax credits.³² Rental losses from investment properties are not added back in determining WfF entitlement.

2.3 The sustainability of the current tax system

There are four major issues impacting on the sustainability of the tax revenue base in New Zealand:

- Compliance is likely to be affected by perceptions that the system is unfair.
- International competition for capital and labour, especially from Australia, will impact on the sustainability of corporate and personal tax rates.
- Fiscal drag is quickly pushing average wage earners toward the top personal tax rate. This will increase incentives to divert income toward lower-taxed entities.
- Demographic change (together with a rising cost of financing higher public debt) is placing higher demands on the tax revenue base while simultaneously placing greater tax pressure on a smaller proportion of the population.

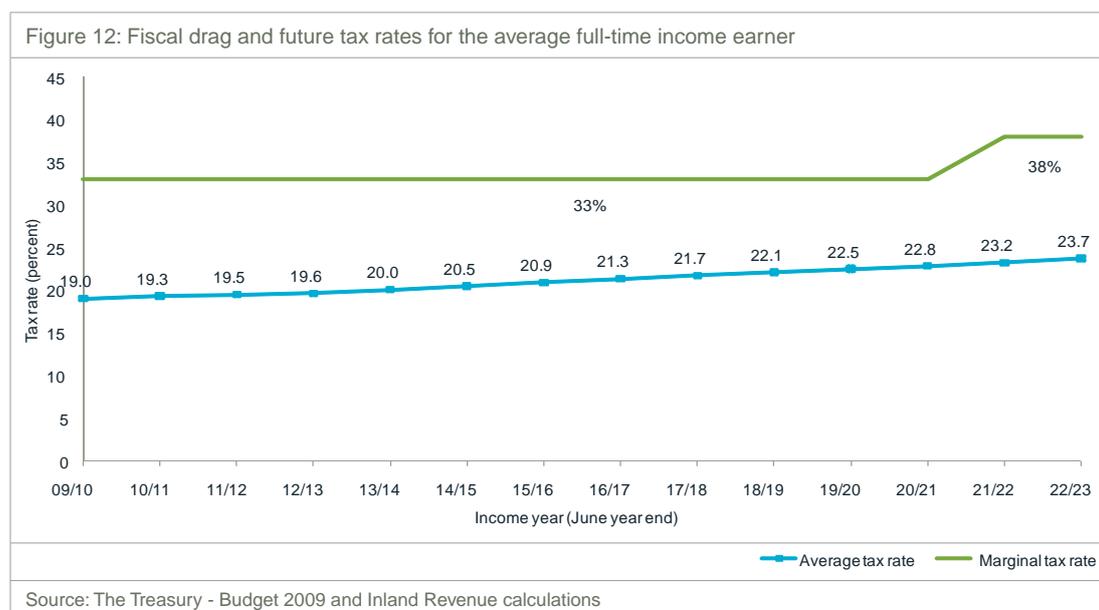
The equity considerations discussed in the previous section have important implications for the long-term viability of the tax system as it relies heavily on voluntary taxpayer compliance. Where taxpayers consider the system is unfair and confidence declines, voluntary compliance tends to reduce. This will undermine people's trust in the tax system and put at risk the sustainability of the tax revenue base.

International developments also pose a threat to the sustainability of the tax base. Falling international corporate and personal tax rates increase the risk that the current tax bases (or growth in those bases) are unsustainable. The international environment is changing and becoming more globalised, providing increasing competition for labour (particularly highly skilled labour) and capital. Changes in our close economic neighbour, Australia, are especially relevant for New Zealand. We have a particularly mobile labour force and capital flows readily across the Tasman. If the outcome of the Australian review of its tax system is that Australia moves towards a lower corporate tax rate, the pressures to reduce the current New Zealand corporate tax rate will increase.³³

Fiscal drag, where rising incomes push people into paying higher tax rates over time if there is no change to tax thresholds, means that unless there are changes to the current system the percentage of income earners currently paying the top tax rate will rise from the present 9% to 24% within 15 years. Fiscal drag also means that New Zealand's revenue base is increasingly reliant on personal and corporate taxes, while other countries are likely to become even less reliant on them.

Demographic changes in the form of population ageing will also impact on the sustainability of government expenditure and tax revenues. The recent Long-term Fiscal Statement shows that an ageing population poses considerable fiscal challenges.³⁴ To maintain existing levels of services, the tax base will need to maintain or increase revenues, and there will need to be consideration of alternative bases of taxation in ways that make the tax base less reliant on taxes that discourage participation in the labour force.

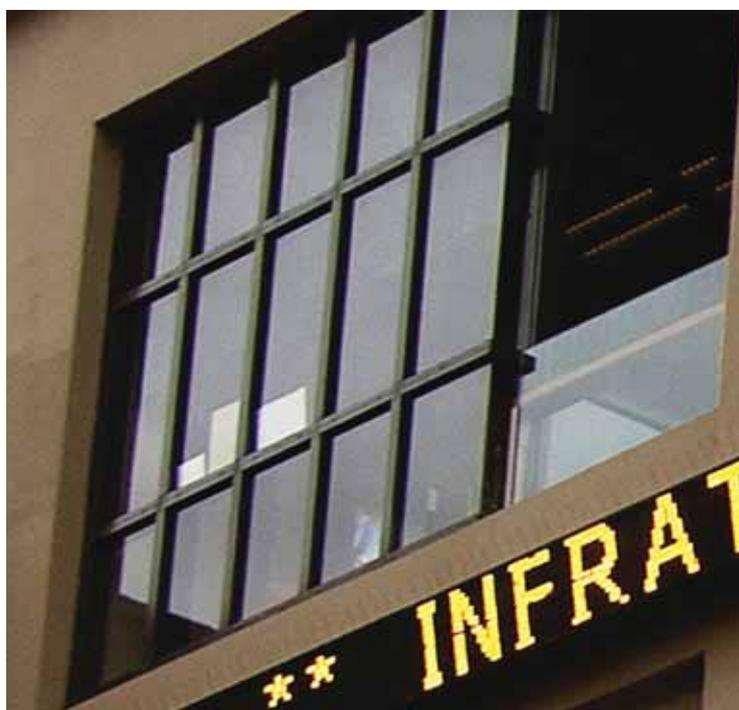
A combination of fiscal drag and demographic changes will mean that marginal and average tax rates for the average worker will increase over the next 15 years if nothing is done. The marginal tax rate facing a worker on the average wage is expected to rise from 33% to 38%, and the average tax rate will increase from 19% to almost 24% over this time (see Figure 12). While this could be alleviated by raising tax thresholds, these would need to be indexed to nominal wage growth rather than inflation to prevent the average tax rate continuing to rise.



The acceptability to taxpayers of a persistently rising average tax rate as shown in Figure 12, and the jump in the marginal tax rate faced by an average wage earner, must be in doubt. While rising real incomes may be associated with a greater willingness to pay a larger fraction of that income in tax, a high marginal tax rate applicable to a wide range of taxpayers is more problematic for labour supply and other incentives. This could be tackled by regular increases in tax thresholds in line with increases in consumer prices so that inflation is not responsible for increasing individual's personal income tax bills. Of course, increases in *real* incomes would continue to push people into higher tax brackets as their incomes rose; this too could be eliminated by increasing thresholds in line with *nominal* income increases. Whereas linking income tax thresholds to prices is quite common in some other countries, such as the UK, linking them to nominal income increases is less common. Indexing income tax thresholds to nominal incomes (e.g. via indexation at the rate of wage or per capital GDP growth) effectively keeps average tax rates constant and so 'turns off' fiscal drag.

Issues such as these would alone justify a serious look at the tax system. The problem for New Zealand is that the current system is riddled with a series of issues which undermine the tax base and government's revenue objectives, the efficient use of economic resources, and fairness.

Ideally, individuals should be able to structure their affairs by relying on the fact that there should be little tax difference between broadly equivalent transactions. People earning their income by salary and wage payments should be able to expect that they will be treated in a similar way to someone who earns the same level of income from property investment. This is not the case in New Zealand. Another concern is that the current system is a bit like walking through a mine field. Unless a taxpayer obtains very good advice on the lay of the land, unexpected and unfortunate consequences can result. The inefficiencies, unfairness and uncertainties arising from the current taxation system are not acceptable.



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Chapter 3: Options for Change to the New Zealand Tax System

The TWG believes the problems with the current tax system are such that it needs to be significantly improved by making changes to its overall structure through a combination of changes to the tax bases and tax mix, to the tax rates, and by improving some of the supporting tax rules. The Group considered a number of options to deal with the concerns identified in the previous chapter regarding the structure of the tax system and implications for international competitiveness and growth, the coherence, integrity and fairness of the present system, and its sustainability. These were judged according to the six principles of a good tax system discussed in Chapter 1. There are also revenue costs and benefits associated with the different options.

Tackling the problems with the overall structure of New Zealand's tax system requires moving towards a system less dependent on taxes that are most damaging for growth. This is also consistent with the reform direction necessitated by the demographic ageing which will intensify over the next 20 years. That is, the tax system should impose minimum disincentives to work and to save for retirement. These objectives suggest a reduction in high rates of tax on labour and capital incomes. A GST also involves taxing labour income whenever it is spent. To this extent, a shift from taxing labour income to GST will have offsetting effects on the taxation of labour income. However, an attraction of a GST is that it does not tax the return to capital and so does not distort savings decisions. Both international studies and New Zealand's relatively broad and efficient GST base suggest that such a change might enhance economic efficiency.

These considerations, along with any preference to maintain progressivity in personal income taxes, point to lower rates of personal income tax. This would improve incentives to work and save. However, it would do little to encourage increased capital investment, except to the extent that domestic investors and entrepreneurs face personal rather than corporate tax on their investments. Our current system of imputation is designed to ensure that domestic residents' 'final' tax rate is their personal marginal rate. However, as the previous chapter pointed out, the lack of coherence and integrity of the current system, means that the 'final' tax rate faced by resident taxpayers is often not their personal marginal rate but a lower corporate or trust rate, or may even be zero for some types of investment.

Addressing the integrity and fairness concerns suggests moving to a system where the same level of tax is imposed on all forms of income or having measures in place which make it difficult to change the form in which income is earned for tax purposes.

In evaluating options for reform, the Group had to consider several system-wide issues. These included:

- i whether it is preferable that the corporate, trust and top personal tax rates be aligned;
- ii if rates were not aligned, whether effective measures can be introduced to resolve the integrity problems that have characterised the present non-aligned system;

- iii whether rates on existing tax bases should increase or decrease;
- iv whether base-broadening measures should be applied comprehensively or whether selective application can be applied efficiently and effectively;
- v whether there are technical changes that could improve the efficiency of the tax system and be consistent with base-broadening and revenue generation; and
- vi the scope to reduce high effective marginal tax rates.

Choices around these issues will be influenced by judgements about the relative importance of integrity, growth and competitiveness, and equity objectives. Hence, the primary focus of this chapter is summarising options and identifying their costs and benefits to help inform policy choices.

To help in identifying the pros and cons of different options, the Group considered a number of scenarios combining various tax reform options, including base-broadening measures. Each scenario has been tested against the principles of a good tax system outlined above. Importantly, the impact of each scenario on household and child poverty, and other equity measures, has also been assessed. Choosing between reform options will ultimately depend on the value judgements that are inevitably required where competing objectives are involved, and the scale of reform that the government is willing to undertake.

3.1 Alignment of top personal, corporate, PIE and trust rates, with imputation³⁵

Under an aligned system, the top personal, company, trust and PIE rates would be set at the same rate.

An aligned set of tax rates (company, PIE, trust and top personal rate) in combination with a full imputation system (where people receiving income from dividends receive a tax credit for the tax already paid by the company) is one way of addressing a number of the integrity and fairness concerns with the current tax system.

Alignment is an attractive option if the principal concerns are with the integrity of the tax system and with ensuring consistent tax treatment for different entities. Alignment also enhances simplicity and tax administration. On the other hand, strict alignment of corporate, trust and top personal tax rates obviously reduces government discretion over changes to tax rates. This might be problematic in a small open economy facing changes to competitive global corporate tax rates or even personal tax rates. These circumstances pose risks to the sustainability of an aligned tax system.

The advantages and disadvantages of an aligned system can be summarised as follows:

Advantages	Disadvantages
<ul style="list-style-type: none"> ■ Enhances coherence and integrity of the system. ■ Increases horizontal equity by taxing different income sources similarly. ■ Increases efficiency by reducing incentives to defer or avoid tax through shifting personal activity and assets to closely held companies or trusts. ■ Alignment with a lower top personal tax rate Improves incentives on decisions to work and encourages skilled labour to remain in New Zealand. ■ Reducing personal tax rates may increase domestic savings and investment. ■ Administratively simple and low compliance costs as no tax sheltering rules are required. ■ Imputation has some attractive neutrality properties, in particular, equal treatment of investments through entities and of debt versus equity financing.³⁶ It also caters for the possibility of the mutual recognition of imputation and franking credits with Australia. It allows New Zealand to tax New Zealand source income of non-residents and ensures New Zealand residents are taxed on domestic and foreign source income earned through companies. ■ Imputation is a buttress to the company tax. 	<ul style="list-style-type: none"> ■ May not be sustainable due to international pressures to reduce company tax rates. ■ May be less efficient than a non-aligned system that allowed deeper reductions in the company tax rate in response to lower international company tax rates. This is particularly so if capital income is more important than labour income for growth. ■ Reduces progressivity and vertical equity by reducing top personal tax rates. ■ Vulnerable to political economy pressures to alter top personal tax rates independently of the company rate. ■ Fiscal cost could be high if top personal rate has to fall in line with lower future company rates. ■ If alignment is achieved and sustained by company rate remaining high, there are possible incentives to stream profits away from New Zealand. ■ Imputation is harder to sustain if Australia abandons it.

Achieving an aligned tax system probably requires a government to be willing to cut top personal tax rates to 30%, and further if it chooses to reduce the company tax rate. If other countries continue to cut their company rates, this simple system may not be sustainable. For these reasons, we have also considered tax reform options involving non-alignment. At the very least, however, the rate applying to trusts, and the top PIE (and other savings vehicles) rate should align with the top personal tax rate.

3.2 Non-alignment of personal, corporate, PIE and trust rates

The TWG considered a number of non-aligned options, including:³⁷

- A classical system with a low company rate, no imputation, and rates of personal tax at current levels backed with measures to prevent sheltering of income.
- A 'dual income tax' system which distinguishes companies' and individuals', 'labour' and 'capital' income separately, rather than distinguishing personal from corporate income. This has been adopted in some Nordic countries.
- A 'dual income tax' system with allowance for corporate equity.
- A non-aligned system combined with a reduced form of imputation.

Classical system with a low company rate and higher rates of personal tax

One way that New Zealand might be able to implement a substantial cut in its company tax rate in response to international corporate tax rate reductions, while maintaining a higher top personal tax rate, is to have a traditional classical tax system. A classical tax system, such as that in Ireland, taxes fully at both the company and shareholder level, so does not have imputation. This would involve:

- A low tax rate on company profits.
- Abandoning imputation.
- A personal tax rate higher than the company rate.
- Various measures to prevent other taxpayers from taking advantage of this low company rate, such as a capital gains tax on company shares.

This form of non-alignment has a number of different advantages and disadvantages:³⁸

Advantages	Disadvantages
<ul style="list-style-type: none"> ■ Could attract foreign capital, and boost labour productivity with a low company tax rate while continuing to tax domestic workers and savers at higher personal tax rates. ■ Reduces incentives to stream profits and move business functions away from New Zealand. ■ Less fiscal cost for a company tax rate reduction than a system aligned with an imputation regime. ■ Avoids having to make the personal tax system less progressive by allowing cuts to the company tax rate without requiring cuts to the top personal income tax rates. 	<ul style="list-style-type: none"> ■ Double taxation of dividends paid to residents (no credit for tax paid at company level). ■ Domestic resident savers and investors face a higher tax rate than foreign residents. ■ Reduced incentives to save and less attractive for capital to flow to small and medium enterprises (SMEs) ahead of lightly-taxed investments, such as housing. ■ Increased pressure to restructure income flows to derive taxable income through a company, eroding the personal income tax base. ■ Creates a preference for debt over equity investment, affecting the flow of risk-taking capital. ■ Requires additional anti-avoidance measures. ■ More complex to administer. ■ Additional revenue (from removing imputation) not sufficient to provide a substantial company rate cut.³⁹ ■ Low company rate reduces taxation of any location-specific economic rents in New Zealand. ■ Tax biases affecting choices over business organisation, retention over distribution, and debt versus equity financing. ■ Only partially addresses concerns regarding the taxation of capital. ■ Higher tax rates on labour income create inefficiencies and increase incentives for higher-skilled workers to migrate.

While in principle a classical tax system would provide greater scope for government discretion to set separate corporate and top personal tax rates, it does pose risks to the integrity and fairness of the tax system. These integrity risks are likely to increase tax administration costs.

Dual income tax system

An alternative model to address the international competitiveness and integrity problems with the current tax system is a dual rate tax system. This involves a move to different tax rates for labour and capital income. Under a dual income tax system, capital income is typically taxed at a flat low rate, whereas labour income is taxed progressively. Countries which have adopted this sort of tax system have done so on the rationale that taxes on investment and saving impact more negatively on economic behaviour than a tax on labour. The idea has been to preserve high tax rates on labour income while responding to international pressures which make sustaining such rates on capital income problematic.

How such a system might operate depends very much on the design details. Norway has the most comprehensive and consistent dual income system and the advantages and disadvantages listed below focus on Norway's tax system. Their system separates capital and labour income and taxes them at the appropriate rate, regardless of the type of entity through which the income is earned. This approach is generally applied as follows:

- For sole traders, a deemed return (based on a risk-free government bond rate) is imputed on the value of the assets used in the business and is taxed at the capital income tax rate. Income in excess of this amount is presumed to be from labour and is taxed at the personal tax rate.
- Company income is initially taxed at the capital tax rate. However, distributions from the company up to the risk-free return amount are not taxed, but distributions in excess of the risk-free return amount are taxed again at the capital rate – the double tax approximates the top labour tax rate. Capital gains from selling shares are subject to similar treatment. This treatment is not limited to companies with shareholder-employees, but to all companies. This has the effect of taxing economic rents earned by resident shareholders through the company at a higher tax rate.

The main advantages and disadvantages of this option are:⁴⁰

Advantages	Disadvantages
<ul style="list-style-type: none"> ■ Provides a more coherent and systematic shift to lower capital tax rates than recent New Zealand policy changes such as the PIE regime. ■ By allowing for a lower company tax rate it can increase in-bound investment and economic efficiency. ■ Allows for the possibility of higher tax rates on labour income to be maintained thereby enabling a more progressive tax system and increased vertical equity. 	<ul style="list-style-type: none"> ■ Reducing the tax rate on capital might be regressive (since capital income tends to be earned disproportionately by those on higher incomes) and may be perceived as reducing vertical equity. ■ Introduces new boundaries between income types; creates incentives to re-characterise labour income as capital, particularly where above normal profits would be subject to double taxation (at the personal income tax rate). ■ Complex to administer and comply with. ■ Disincentive to risk-taking where above-normal return is double taxed. ■ Low capital tax rate reduces taxation of any location-specific economic rents earned by non-residents in New Zealand. ■ May reduce savings via higher (flat rate) tax on capital earned by those on low incomes. ■ Higher tax rates on labour income will create inefficiencies and increase incentives for skilled labour to migrate.

The dual income tax system, as with a classical system, provides scope for greater discretion to set separate corporate and top personal income tax rates. However, incentives to re-characterise labour income as capital income can give rise to boundary issues not dissimilar to the type of integrity problems that exist under the present New Zealand tax system. Furthermore, at least for New Zealand where skilled labour is highly mobile, the scope that a dual income tax system provides to set higher personal tax rates may be more limited if governments are concerned with efficiency and the effects of high personal tax rates.

Dual income tax system with allowance for corporate equity

An interesting idea the TWG considered was a combination of a dual income tax applying domestically with an allowance for corporate equity (ACE) applying to investments from non-residents. This was an idea proposed in a paper by Sorensen and Johnson prepared for Australia's Future Tax System Review.⁴¹ This approach is intended to capture the advantages of both a dual system for taxing capital income at a lower rate than labour income, with an ACE system for taxing economic rents earned by non-residents, without discouraging additional marginal investments.

The system would generally require:

- A deduction against taxable income for the normal return on new equity invested by non-residents in a domestic company (the ACE deduction).

- A dual system applying generally to residents (tax rate on wages higher than the tax rate on capital income).
- Measures to ensure that capital income earned in companies owned by domestic residents is taxed at the shareholder level, including dividend taxation.
- An accrued capital gains tax on residents' ownership of shares in publicly traded companies, and an excess retention tax on undistributed earnings of other domestic companies.

While the TWG thought this approach was innovative and may be worth considering at some time in the future, a system like it is untested (it has never been implemented) and it also raises significant transitional and implementation issues. The Group felt that if company and personal tax rates could be reduced to moderate levels as suggested in this report, the extra complexity and implementation risk of the Sorenson and Johnson proposal would not be warranted.

Non-alignment with imputation

The Group also considered the possibility of adopting a non-aligned structure while retaining imputation. This could include retaining the 38% top personal tax rate or it could include lowering both the corporate and personal tax rates while maintaining a large gap between them. Non-alignment options may be feasible provided other reforms are introduced at the same time. This option is important if governments want to be able to drop the corporate tax rate to match a fall in international or Australian corporate rates, without a commensurate drop in personal rates. Non-alignment will require new tax structures and tax rules to establish coherence and to overcome the integrity problems that pervade the current taxation system. The experience of the last decade suggests that as the gap between the corporate, trust and top personal tax rates increases, the integrity issues are accentuated and the more important these measures become.

Measures required to support non-alignment

Non-alignment of rates provides an opportunity for individuals to structure their affairs so that they derive income in a form that is subject to lower tax rates. Members of the Group felt that minor differences between corporate and top personal tax rates (say, differences of 3% or less) may be able to be tolerated as part of the tradeoffs explicit in a coherent system. However, alignment at the top personal, trustee and PIE rates would still be advised. If any form of non-aligned structure was adopted where there are significant differences between rates, it would be essential that measures are put in place to restore coherence and integrity. Examples include:

- A surcharge on the after-tax investment income of closely held companies (excluding companies controlled by widely held companies) if it is not distributed within, for example, 18 months of financial year end.
- Taxing the capital gain on shares at full personal marginal tax rates, either on an accrual basis or on realisation. This would largely remove the tax advantage of converting retained corporate profits into the untaxed proceeds of a sale of shares.

As a result of the integrity measures that would be required, a non-aligned tax system would be more complex to administer and comply with than the current tax system. On the other hand, it would provide scope for greater discretion over the separate determination of corporate and personal tax rates. These trade-offs suggest therefore that while integrity, simplicity and administration cost considerations tend to lead to a preference for alignment, international competitiveness and (vertical) equity considerations tend to lead to a preference for a non-aligned system with measures introduced to restore integrity.

3.3 Ways to broaden the tax base and fund tax reform

Whatever company tax system is adopted and whether aligned or not, reducing reliance on personal and corporate taxes would have medium-term fiscal, or tax revenue, costs of various sizes. Table 2 provides estimates of the fiscal costs for a selection of aligned and non-aligned options. These estimates are based on the current distribution of economic activity and incomes and do not attempt to estimate the tax revenue effect of any subsequent changes to economic activity in response to the tax changes, such as increased productivity or real incomes.

Table 2: Fiscal costs of a selection of aligned and non-aligned systems⁴²

Fiscal Cost in 2009/10 tax year (in \$ billion)				
Aligned	Aligned	Aligned	Non-aligned	Non-aligned
30-30-30	27-27-27	25-25-25	30-30-25	33-33-27
\$1.6	\$3.1	\$4.1	\$2.3	\$1.1

Note: 30-30-30, for example, refers to the top personal, the trust and corporate tax rates in that order. All examples are written in this order.

The TWG has considered options to meet these costs and to improve the coherence and integrity of the tax system. This has included increasing GST and broadening or introducing new tax bases. Base-broadening options warrant consideration as a means of achieving necessary improvements to the tax system. As well of course, they would provide the extra revenue necessary to allow reductions to corporate and personal tax rates.

These alternatives and their pros and cons are discussed below. These alternatives need to be weighed up as part of any comprehensive tax reform package. The main revenue-raising options considered, along with approximate indicative costs (based on 2009/2010 prices and tax rates and distribution of economic activity and incomes), are summarised in Table 3. These include raising the rate of GST, more comprehensive taxation of capital gains, a land tax, and a risk free return method (RFRM) applied to rental property. Also included are other measures that could improve the system and raise additional revenue, including removing, or reducing depreciation on some assets and changing thin capitalisation rules applying to foreign investment.

Table 3: Revenue-raising and base-broadening options

Option	Indicative annual fiscal revenue (\$ billion in 2009/10 prices)	Comment
Raising GST <ul style="list-style-type: none"> ■ to 15% ■ to 17.5% 	<ul style="list-style-type: none"> up to \$1.9 up to \$3.7 	These estimates include automatic adjustments to benefit levels and superannuation payments. Substantially less revenue if there is other compensation for lower income groups.
Extending the tax on capital gain income – <ul style="list-style-type: none"> ■ Comprehensive ■ Excluding owner-occupied housing 	<ul style="list-style-type: none"> up to \$9.0 up to \$4.5 	Estimates are based on full implementation, accrual basis and 2% rate of real property inflation. Lower revenue would be expected with a realisation-based tax, particularly during implementation. Revenue generated will also depend on the particular design of the CGT.
Land Tax	up to \$2.3 (for 0.5% tax rate)	Based on an assumed limited fall in land prices due to tax; revenue reduced by about \$0.6bn if land tax is deductible against taxable income for businesses.
RFRM on residential investment property	up to \$0.7 (plus up to \$0.15 in tax saved on loss offsets)	Based on 6% (nominal) risk-free return; rental property only. This estimate excludes other residential investment property (e.g. second homes).
Remove depreciation on buildings	up to \$1.3	Based on no loss offset if buildings sold at a loss; estimated cost of allowing loss offset = \$300 to 600 million.
Remove 20% depreciation loading on new assets (excl. buildings)	up to \$0.3	Lower revenue gain if loading reduced rather than eliminated.
Changes to thin capitalisation rules	up to \$0.2	Changes thin cap 'safe harbour' from 75% to 60%.

As with the other components of possible tax reform packages, the revenue-raising and base-broadening options have been assessed using the six principles of a good tax system.

Most of the base-broadening options involve changes to the taxation of various forms of capital or capital income. In all such cases an important consideration is whether the nominal (including inflation) or real (adjusted for inflation) value of assets or capital income should be taxed. In general, taxation of all forms of *real*, rather than nominal, income is preferable. However, for capital income this issue is especially important since it is readily shown that in the presence of even moderate inflation the effective tax rate on real capital income can be substantially higher than the statutory rate. The TWG received advice that, in principle, there could be substantial reductions in effective tax rates on capital income by taxing only the real component of, for example, interest income.⁴³ Though the Group did not address this issue in detail, for each of the capital tax base broadening options described below, the choice of whether to tax real or nominal bases would need to be addressed.

Increasing the GST rate⁴⁴

This option involves raising the rate of GST, while maintaining the current base and other GST settings. The specific rate examined in alternative scenarios was 15%, but smaller or larger increases could be considered.

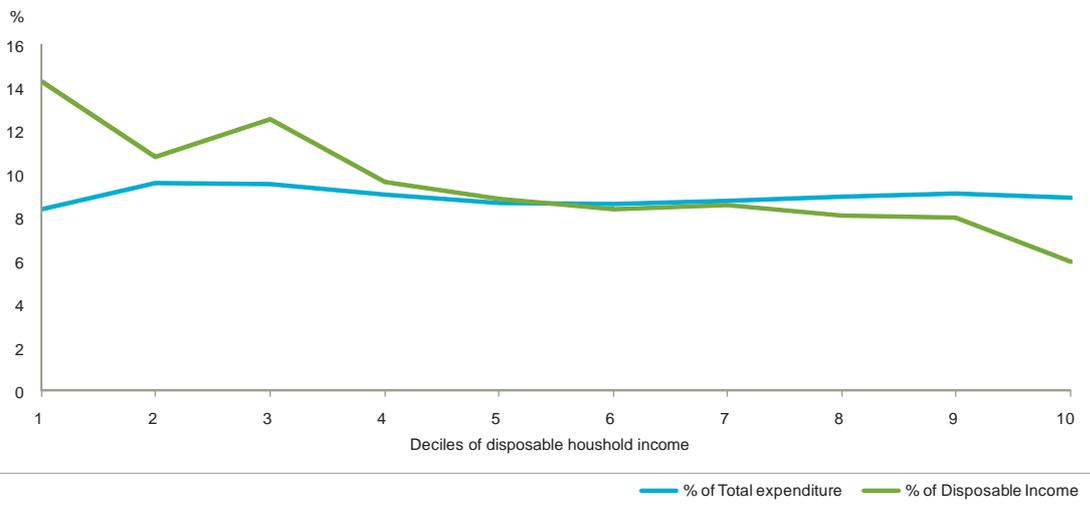
GST is paid by New Zealand households and overseas visitors either directly (where charged on end-use goods or services), or indirectly (e.g. where firms' prices are higher because they cannot claim back input credits, such as in the financial sector). To the extent that GST is paid by overseas visitors (estimated at 5% of private sector GST revenues) a switch towards GST allows more revenue to be raised from non-residents than through the income tax system.

Using GST to fund tax reform has benefits from a growth and efficiency perspective. GST is a less harmful tax than an income tax as it does not discourage savings. It may also be less harmful to labour supply if levied at a uniform rate, compared to the existing structure of progressive income tax rates. Some evidence suggests that this would be favourable for economic growth. New Zealand's GST also has a broad base and few exemptions. This means GST has a lower cost of collection and is a relatively efficient tax. Increasing the GST rate to fund tax reform would also mean that the existing framework for administration and compliance would not need significant change.

These efficiency and administrative advantages need to be considered alongside the impact on equity and fairness. There are concerns that a switch toward GST may disadvantage particular groups. For example, raising the rate of GST increases the tax on existing wealth because past accumulated savings would now face a higher tax rate when spent. This can hit older age groups who have accumulated savings from past income but now have limited income-earning ability.

Another common concern is that those on lower incomes on average pay a higher percentage of their disposable income in GST than higher income households. However, the impact of this difference should not be overstated. The percentage of disposable income paid in GST is largely accounted for by the difference in savings and dissavings across income levels. Because people spend income over time, actual spending may be a better measure of lifetime income. For this reason, GST as a proportion of expenditure is roughly proportional across all income levels over time (see Figure 13). This reflects the fact that people tend to base their current spending decisions on, not simply their current income, but also their expected life-time income. Despite this, there may still be a desire to address immediate equity issues that could arise from increasing the GST rate.

Figure 13: GST paid by households



Source: The Treasury and Statistics New Zealand

The TWG considered whether this could be done through exempting certain basic necessities from GST. However, narrowing the GST base would substantially reduce the efficiency of the tax and increase compliance and administration costs, while having limited impact on equality. For example, removing food from the base makes almost no difference to the distribution of the tax across income levels, but loses 20% of GST revenue. This fall in revenue would then need to be recovered by higher rates of GST, or by increasing other taxes. Consideration was also given to the implications of allowing tourists to recover the GST paid on goods purchased in New Zealand. The Group was advised that, in addition to the loss of revenue, there would be significant administrative costs involved in administering the scheme (including costs incurred in reducing the opportunity for goods to be purchased on behalf of New Zealand residents).

The TWG therefore recommends that any equity concerns associated with increasing the rate of GST are instead addressed through compensation for lower income earners and benefit recipients through existing mechanisms, such as an increase in benefits or New Zealand Superannuation, or through other mechanisms as appropriate. Reducing lower rates of personal income tax provides another means of countering undesirable distributional effects from increases in GST rates, although this may be a less efficient approach. This can also be fiscally costly because cuts to lower rates of taxes benefit high as well as low income earners.

The impact of increasing the GST rate on revenue integrity also needs to be considered. A higher GST could increase incentives to avoid GST through switching away from goods subject to GST. It will also increase risks with respect to GST refunds and fraud. However, in the event of a moderate rise in the GST rate, the Group considers these risks would be manageable, although increased enforcement and maintenance may be necessary.

The TWG also considered the feasibility of extensions to the GST base such as applying GST to financial services and on imputed rents of owner-occupiers and housing rental more generally. The Group was advised that taxing financial services is problematic because their value is difficult to measure. The valuation and cash-flow issues involved in charging GST on imputed rents are similar to those that arise with the base broadening options for extending the taxation of capital. In any event, to the extent the cost of construction of new residential property is reflected in rents, the GST component of building services and supplies will also be reflected in rents.

Extending capital gains taxation⁴⁵

Although New Zealand has a general “broad base, low rate” framework for taxation, a large component of economic income, capital gains, are not taxed or are taxed in an *ad hoc* fashion. Taxing capital gain income ‘on accrual’ (that is, as the gains arise on a year-to-year basis rather than when assets are sold) would bring the tax system closer to taxing comprehensive economic income. In principle, this would make the tax system more efficient by reducing any bias between savings and investment decisions, and more horizontally equitable by taxing people equally regardless of the nature of their income.

Other reasons for bringing capital gains within the tax net are that:

- it reduces bias in favour of investment in assets expected to create capital gains;
- non-taxable capital gains can presently be earned as an alternative to taxable income, creating a distortion to investment choices and a risk to the revenue base, as discussed in Chapter 2;
- there is currently uncertainty concerning whether some capital gains are taxable, and this can distort saving and investment decisions; and
- the experience of several countries suggests a more comprehensive capital gains tax can provide substantial revenue to finance changes elsewhere in the tax system. Although CGT revenues can fluctuate widely, the Australian Federal Government has collected on average over the last 10 years, 3.9% of its total annual tax revenue from its capital gains tax.

In practice, taxing all capital gain income on accrual is not feasible (and no country has implemented it) due to such problems as identifying market values for some assets and the cash-flow difficulties that arise when accrued capital gains generate immediate tax liabilities but the assets yield no immediate (cash flow) returns.

Nevertheless, the TWG received advice that taxing some classes of assets (such as shares, and some business assets) on accrual may be feasible. Hence, the main question addressed by the Group was whether a more comprehensive realisation-based tax or a combined accrual-realisation tax would improve the current tax system when measured against the criteria of efficiency, equity, integrity, simplicity and coherence.

New Zealand currently taxes specific capital gains to varying degrees such as certain land transactions, dealings in personal property (e.g. shares), financial instruments (through the financial arrangements tax rules), foreign shares (through the fair dividend rate regime), and some intellectual property (e.g.

patents). This approach is inconsistent and results in what is often in substance the same form of income being taxed in different ways, at different rates, or not at all. Under the current rules there is an incoherent mix of taxation and this mix includes differences in bases for calculating capital gains. This is unsatisfactory.

Whether a capital gain is taxable will generally depend on a range of factors including:

- i the asset class invested in;
- ii the form of entity making the investment;
- iii the location of the investment (whether New Zealand, Australia or elsewhere);
- iv the period of the investment (for some property transactions); and
- v investment intentions.

This inconsistent treatment breaches all the principles of a good tax system.

The Group identified some key elements relevant to the consideration of whether or not New Zealand would benefit from a comprehensive taxation of capital gain income. These are:

- Whether CGT, on balance, would improve or worsen the efficiency of New Zealand's capital income tax system; for example, by increasing 'lock-in' and cash-flow aspects versus equalising the tax treatment of different capital income flows.⁴⁶
- Outcomes would be influenced by whether owner-occupied property was included or excluded from the tax. If excluded, there would be a bias towards investing in primary residences. Excluding owner-occupied housing, however, would be desirable if the main concern was to increase the progressivity of the tax system. However, this would mean a significant percentage of real property is outside the CGT.
- How much a CGT would improve the integrity of the current system.
- Whether there are better ways of broadening capital gains taxation without a formal CGT. These might include an RFRM-based tax on equities and/or property, or taxing only the real component of interest income.
- The benefits from a CGT buttressing the personal tax system and reducing avoidance.
- The extent revenue from a CGT will allow efficiency gains from lower tax rates on all income.
- Whether administrative arrangements with a CGT would be more or less costly than currently.
- A capital gains tax on share sales would in some circumstances result in double taxation of corporate profits. Could this be satisfactorily addressed through the imputation system?
- How to deal with the over-taxation caused by a CGT through methods such as indexation or deferral until realisation.

A comprehensive capital gains tax can be viewed as providing, along with the corporate and personal income taxes, a more comprehensive taxation of income, including current returns for services from owning assets plus changes in the value of assets owned. While a CGT has attraction as a means of base broadening by taxing a more comprehensive measure of income, the Group nevertheless recognised there are also concerns with the application and administration of a CGT arising from cash flow and valuation difficulties.

In response to these issues, a typical CGT applies only on realisation, excludes owner occupied housing, and quarantines capital losses. As a result, there may be concerns with efficiency if there are significant 'lock-in' effects created by a realisation based CGT or if ring-fencing of capital losses discourages risk-taking. Boundary problems also arise if significant classes of assets are excluded and the tax may not generate material revenue if losses are allowed as a deduction. These concerns are not peculiar to a CGT; they also apply, to varying degree, to other options considered for broadening the tax treatment of capital.

Land tax⁴⁷

A land tax can be regarded as a more selective form of base broadening since it applies to one form of capital. In New Zealand, there is currently a low use of recurring land and property taxes. A land tax would impose an annual tax liability on landowners, calculated by reference to the value of land owned by them. As a base-broadening measure, land tax has a number of merits.

Firstly, land is an asset that is in fixed supply, (i.e. 'perfectly inelastic'), and therefore cannot respond to economic incentives or disincentives such as taxation. Accordingly, the burden of land taxes would be borne by land owners at the time the tax is announced and cannot be passed on. This makes a land tax an efficient tax by not imposing any distortions on economic behaviour, provided the tax is imposed at a single rate across all types of land.

Secondly, because of the size of the land base (valued at approximately \$450b to \$480b, prior to any negative impact on land values as a result of the imposition of the tax) a large amount of revenue could be raised at a low rate.

Thirdly, local government authorities currently levy local 'rates' based either on land or property values and it is relatively straightforward to obtain both these values for properties across New Zealand, although there may still be concerns about the accuracy and methodology used to calculate values. This suggests that a land tax may be an administratively easy tax to introduce and administer, whether collection is by the Inland Revenue Department as a new type of tax or whether done so in association with the local authority rates collection processes. While Inland Revenue would need additional funding to administer a land tax, this additional funding should be less than would be required to administer some of the other base broadening measures considered, such as a comprehensive CGT or RFRM-based tax.

However, a land tax would be expected to cause an initial fall in the value of land by up to the net present value of the expected future land tax liabilities. Hence, a land tax constitutes a lump-sum tax on those who own land at the date of its introduction. The size of the drop in land values will depend on the rate of tax and the expected fall in net-of-tax real returns from the land.⁴⁸ This will tend to adversely affect existing land owners and others who have invested directly or indirectly in land. For example, people who currently have heavily geared land holdings may have negative net equity following any land price falls. On the other hand, the introduction of a land tax would be expected to reduce net foreign borrowing.

Given the land value reduction, existing rents may not increase as returns based on land values may not change (where a landlord acquires land post the introduction of the land tax). Alternatively, existing landlords may want to increase rents to cover the additional costs. The drop in land values will put pressure on property developers to develop existing land as soon as possible rather than retaining this for future development.

While a land tax may address current concerns about the New Zealand tax system by causing a rethink by property investors, it will not address the residential rental tax advantage.

The equity impacts of a land tax are also unclear. Firstly, it taxes only one component of wealth, and therefore mainly impacts those people and organisations holding their wealth in that form. Retirees, Maori authorities and farmers could be particularly affected. Tax bases that use broader measures of wealth, income or consumption better meet social conceptions of horizontal equity.

Annual payment of land tax liabilities may also give rise to cashflow issues for some landowners with lower income levels, such as retired people. A possible solution would be to allow these taxpayers to defer the tax (plus an interest charge) until sale or death. However, most estates that seek deferral will have major liabilities for land tax. There would also be lock-in effects for those in deferred payment schemes, although this could be mitigated with some form of roll-over relief.

The significance of some of these effects will depend on the rate of tax set and how far other offsetting mechanisms are used – such as rebates of the type used currently to limit the impact of local authority rates on poorer households.⁴⁹ Equity impacts may lead to pressure for exemptions, which raises concerns about the sustainability of such a tax.

The Group also considered some options for reducing the burden of a land tax on land extensive activities. One such option is a value-per-hectare threshold below which no land tax is payable. This would tend to shield land extensive activities such as farming and forestry. To the extent there is a positive association between land values and incomes, this type of threshold may also ease the tax burden and cashflow concerns for lower-income families. As a result, this proposal might ameliorate some of the equity concerns without accentuating integrity and revenue sustainability problems.

RFRM on property⁵⁰

Under this option, real property, or some subset such as rental housing, would be taxed under a risk-free rate of return (RFRM) method. Instead of taxing the owner on gross rents and allowing a deduction for expenses (including interest and depreciation), imputed income would be calculated by applying a risk free rate to the equity that the owner holds in the property each year and taxing the result at the taxpayer's marginal tax rate.

In theory, an RFRM tax has the same allocative efficiency benefits of a comprehensive income tax, but it may overcome some of the disadvantages of a realisation-based CGT, such as lock-in and revenue volatility. For an RFRM to be efficient:

- it should be based on the market value of the underlying investment;
- the deemed return rate should be the risk-free rate; and
- all returns in excess of the risk-free rate should solely be due to risk premium or risk volatility (no economic rents or returns to labour could be bundled into the return).

In this context, an RFRM applies most cleanly to simple portfolio investments, such as overseas portfolio shares. It could also apply to simple investments in real property. It would be difficult to extend RFRM to more complex businesses that generate considerable returns to labour that may also enjoy an element of untaxed capital appreciation, such as farms, or to situations where investors earn above normal profits (referred to as economic rents). Consequently, this is likely to limit the ability to use RFRM as a platform for further extending the capital income tax base beyond the addition of residential property.

In weighing up the merits of this option it is important to decide whether it is to be applied to all property, only residential property, or restricted to residential property excluding owner-occupied property. Extending the base as widely as possible would have the merit of raising more revenue and minimising distortions that arise from boundary issues when some assets are exempt from tax. Therefore, including owner-occupied property within the RFRM regime would raise many of the same issues as with a CGT or land tax that includes owner-occupied property.⁵¹

Box 4: Illustrations of a RFRM tax on property

- A person owns an investment property that is valued at \$300,000 and is financed by a mortgage of \$200,000 and equity of \$100,000. Suppose this person's marginal tax rate is 38% (because their salary income is in excess of \$70,000). Suppose also that the annual risk free return (i.e. the annual return from a risk free asset), is 4%.
- The RFRM taxable income applied to this investment property is:
$$\$300,000 \text{ less } \$200,000 = \$100,000 \times 0.04 = \$4,000.$$
- The additional annual tax liability for this person (i.e. the tax payable over and above their personal income tax liability) is $\$4,000 \times 0.38 = \$1,520$.
- Suppose two people, person A and person B, have equal shares in an investment property that is valued at \$500,000 and is financed by a mortgage of \$300,000 and equity of \$200,000. Suppose person A's marginal tax rate is 38% and person B's marginal tax rate is 21%. Suppose also, as before, that the annual risk free return is 4%.
- The RFRM taxable income applied to this investment property is:
$$\$500,000 \text{ less } \$300,000 = \$200,000 \times 0.04 = \$8,000.$$
- And suppose this taxable income is split equally between these two people. Then
Person A's additional annual tax liability is $\$4,000 \times 0.38 = \$1,520$.
Person B's additional annual tax liability is $\$4,000 \times 0.21 = \840 .

The case for applying RFRM to various assets depends on a number of factors, including:

- The size of efficiency and growth benefits. An RFRM applied, for example, to residential property, including owner-occupied housing, may encourage a shift in asset ownership away from housing and towards assets that contribute more directly to the economy's productive potential.
- The extent to which these benefits might be reduced if owner-occupied housing was omitted from the RFRM tax base, or more generally by having some assets taxed under RFRM and others taxed under other rules.
- The extent to which an RFRM may under-tax the returns to labour or any economic rents earned. This would occur if these rents were not reflected in the value of equity. For example, a property may be improved by the owner using their own labour.
- The accuracy of the risk free rate of return. The rate adopted should ideally reflect the actual risk-free rate for the RFRM to be neutral in comparison to investments subject to a comprehensive income tax. Using a nominal rate of return rather than a real rate may also have less impact on the relative incentives to finance investment by debt versus equity.

- How equitable an RFRM might be. It may be progressive if applied only to rental property (because wealthier households tend to own more rental property) but, as with a CGT on rental property, this would depend on how far landlords could pass on their increased tax liabilities into higher rents. Applying RFRM to some assets and not others also has equity effects by changing the distribution of wealth between owners of different classes of assets.
- How large the integrity issues of an RFRM applied to property might be. For example, would rules be needed to deal with assets with mixed uses or where borrowings are used for several purposes of which rental property is just one?

Addressing many of these issues is not straightforward, not least because an RFRM system is largely untested. A version currently applies in New Zealand, but only to income on foreign equities.^{52 53} Although there may be some scope for also applying an RFRM to rental housing, further work would be required to understand the full implications.

A capital charge

An approach that is similar in some ways to a land tax is to impose a tax of, say, 1% on the value of all capital employed in the economy. Owners of capital derive certain benefits from capital that are currently not taxed such as, for example, greater financial independence and security.⁵⁴ These arguments are also used to justify wealth taxes which tend to be applied more to personal wealth. There are, however, a number of significant issues that would need to be addressed if a comprehensive tax on capital were to be considered. These include ensuring that the tax did not result in capital being overtaxed in relation to labour, determining the scope of any exemptions and developing rules for hard to value assets. While a capital charge may be less discriminatory in its approach than a land tax, a comprehensive capital charge, in contrast to a land tax, would tax capital that is not in fixed supply, (i.e. not 'perfectly inelastic') and therefore can respond to the disincentive that a capital charge would impose on holding capital. For this reason, investment responses to a capital charge could have adverse implications for the rate of investment and productivity growth. For this reason also, estimates of potential revenue are highly uncertain.

Other base broadening options⁵⁵

A number of technical changes to the existing tax system could also be used to broaden the tax base and raise revenue for tax reform. The TWG was presented with a study by Chen and Mintz (2009) which compares the marginal effective tax rate on investment in New Zealand with that for other countries. This study found that while New Zealand had an above average company tax rate compared to the 30 countries studied, its marginal effective tax rate was relatively low. The reason for this is largely due to New Zealand's tax depreciation rates in a number of areas, which are higher than economic depreciation rates. This tends to bias investments into certain depreciable personal property and creates capital allocation distortions. While the Group does not take this study as conclusive, as these issues are complex and require thorough analysis, it does give indicative support to the conclusion that the 20% depreciation loading that applies to certain new assets is distorting investment decisions and the neutrality of the tax system would be improved by removing it.⁵⁶

In its discussion, the Group considered that it was illogical to have the tax system providing tax benefits through depreciation on assets that were appreciating in value. The TWG therefore considers that changes to depreciation rates along with some other technical changes could improve the efficiency of the tax system, broaden its base and provide fiscal savings. These changes include:

- Denying depreciation on all or some buildings if evidence suggests that buildings do not depreciate.
- Taxing gains on depreciable buildings. Under this proposal, building owners that claim depreciation deductions on a building would be taxable to the extent the proceeds from the sale of that building exceed the tax book value of the building. If the building was sold for less than the tax book value, the difference could be tax deductible.
- Reducing or eliminating the depreciation loading for new assets. This proposal would involve removing or reducing the 20% loading that applies to the depreciation rates for new assets (excluding buildings).
- Changes to the thin capitalisation rules. The thin capitalisation interest allocation rules limit the scope for foreign-controlled entities to load debt against New Zealand operations to reduce tax paid in New Zealand. Under this proposal, the 75% safe harbour in the inbound interest allocation rules would be reduced to 60%.
- If the top personal tax rate and the company tax rate are not aligned, remove the 30% cap on tax payable by PIEs.

In addition, there are ways of potentially raising additional net revenue through investing additional resources with Inland Revenue; initially to reduce taxpayer non-compliance.⁵⁷

As these options are changes to the existing system, they are likely to be relatively easy to implement and involve relatively low compliance or administration costs. By far the largest in revenue-generating terms is the withdrawal of depreciation on buildings. Some evidence suggests that many buildings do not in fact depreciate, raising questions over the merits of effectively subsidising investment in those buildings. The TWG therefore considers that this base broadening option deserves consideration as a means of funding corporate and personal income tax rate reductions.

3.4 Changes to the system of social welfare transfers⁵⁸

Examining the social welfare system is outside the scope of the TWG. However, the Group has considered the interface between personal income taxes and the system of social transfers, mainly Working for Families, because of the effect it has on the tax system, particularly the impact of benefit abatement on effective marginal tax rates.

The objectives of the income tax and transfer system are complex, and will inevitably involve tradeoffs between efficiency, equity, integrity, administration and fiscal cost. A progressive tax system, for example, may aim to redistribute income from those earning more to those earning less. One consequence may be, however, to stifle work incentives for those people facing high effective marginal

tax rates. Welfare policy, including its interaction with the tax system, should not discourage people from participating in the work force. Clearly value judgements are necessary to determine the priority and respective weighting of these objectives.

Examination of New Zealand's current income tax and family tax credit structure shows that while income inequality and poverty rates have remained close to the OECD average, the expansion of the Working for Families tax credits in 2005 has increased the incentives for people to shelter or split income, undermining the integrity of the system, and increasing fiscal costs. In particular, the extension of Working for Families meant that more taxpayers became eligible for greater amounts of assistance further up the income scale.

Combined with previous increases in the top income tax rate, these WfF changes significantly increased the incentives for households to shelter or split their incomes in order to qualify for Working for Families. Some households on incomes significantly above the threshold of \$36,827 are able to use entities such as companies and trusts to structure their incomes in such a way that they qualify for WfF payments; whereas other households on similar or lower incomes do not qualify. This causes integrity problems. The current scheme is also increasingly complex to administer and enforce in part due to the high number of New Zealand families in the scheme. These concerns arise, of course, as a result of the design of both the tax system and the WfF scheme.

High marginal and average tax rates discourage entrepreneurship and participation in New Zealand's labour market, and may encourage trans-Tasman migration. In New Zealand, relatively high marginal tax rates arise when the abatement of WfF of 20% is added to the 33% and 38% personal tax rates. To the extent that high effective marginal tax rates are due to the abatement of WfF, the most targeted way of dealing with that would be to make changes to the abatement rates for families rather than the income tax rates facing individuals.

Of course, Working for Families is part of a much wider system of benefit payments and other government assistance. In our view, changes to the personal income tax system and the transfer system should be considered within this wider context, and need to address more fully the nature of the trade-offs involved across the equity, efficiency, integrity and administrative properties of the current systems. The key point is that the role of the tax system is to efficiently raise revenue, and the Group believes that this should be its focus. While the TWG has the firm view that fairness and equity issues are crucial parts of tax system design, using the tax system to deal with issues of equity and income adequacy for families introduces significant complexity.

The TWG considers that, like the tax system, the existing social welfare system is in need of major review. In particular we recommend that alternative ways of dealing with high EMTR problems be addressed, recognising that there are no simple solutions. As one of its illustrative reform options, the Group considered a reduction in personal income tax rates along with a 'semi-universal' approach to WfF. That is, a non-abating component (of \$2000 per child) paid to all families with children alongside a component that does abate as currently. This helps to meet objectives of reducing high EMTRs but at some additional fiscal cost (about \$700 million in the case examined) and also means that WfF

expenditure is less targeted at those most in need.⁵⁹ Options with flat rate taxes and universal child allowances were also considered and which showed quite different child poverty outcomes. Other options are possible, but they go well beyond the scope of the TWG.

3.5 Institutional reform

Institutional arrangements for developing tax policy matter. The Generic Tax Policy Process (GTPP) guidelines were developed in 1994 to improve policy outcomes by encouraging earlier, explicit consideration of key policy elements and trade-offs, providing opportunities for substantial external input and clarifying the responsibilities and accountabilities of all participants.⁶⁰ Since 1995, governments have followed the GTPP guidelines most of the time, particularly in developing detailed policy and translating it into legislation. Improved detailed policy and legislation have resulted, for example, as officials and Ministers release a series of discussion documents as policy in an area is progressively developed, and as the Rewrite Advisory Panel monitors income tax legislation and reports to ministers.⁶¹

Missing are institutional arrangements for ensuring that the tax system as a whole develops in a way that is coherent and sustainable in the longer term. If the tax system is viewed as one of New Zealand's most important economic and political institutions, with many good reasons for being stable in the longer-term (for example, to realise the efficiency gains from tax reform), tax reform should be viewed as a long-term or quasi-constitutional exercise.⁶²

The TWG recommends that consideration be given by Government to institutional arrangements for ensuring the New Zealand tax system has a stronger focus on achieving and sustaining coherence, integrity, efficiency and fairness. For example, Australia has since 2000 operated a Board of Taxation, a non-statutory body that advises the Australian Government on the development and implementation of taxation legislation and the ongoing operation of the Australian tax system.⁶³



Chapter 4: Conclusions and a Way Forward

4.1 The status quo is not a viable option

The TWG believes the status quo is not a viable option for the New Zealand tax system. The depth of the difficulties with the current tax system coupled with the current economic environment, global competition for capital and labour and global changes in taxation structures provides a once-in-a-generation opportunity to design and start to implement a tax system that will position the country for the future. The key features of this new system would be that it was more conducive to improving economic performance, and would better reflect New Zealanders' desire for fairness.

The current New Zealand tax system was designed in the 1980s for a different set of domestic and international circumstances. Piecemeal changes to certain taxes and tax allowances and welfare policy changes such as Working for Families, while introduced with good intentions, have undermined the coherence and integrity of the tax system and created a system that is unfair and inequitable.

Overlaying these problems is a significant concern that the system is not designed in a way that is consistent with a goal of improving economic efficiency and growth. A good tax system should minimise the harm it does to growth; minimise impediments to people working, saving, investing and innovating; minimise distortions to investment allocation decisions; and maximise the integrity and fairness of the taxation system so that there is widespread trust in it and that taxes paid reflect ability to pay and not opportunity to avoid. A good tax system should also be flexible enough to meet future government funding needs and respond to changing international developments. The present system fails to meet these conditions.

This report has highlighted some of the reasons the Group is concerned about the efficiency, growth, fairness and sustainability properties of the current New Zealand taxation system. For example:

- Compared to Australia our personal tax rates are high at most income levels. This will only get worse if fiscal drag is allowed to force salary and wage earners into higher tax brackets.
- Our use of family tax credits with abatement has resulted in very high effective marginal tax rates for some workers which can reduce incentives to work and can have adverse growth effects.
- New Zealand and Australia both now have relatively high corporate tax rates by OECD standards and there is a strong possibility that Australia may reduce its corporate tax rate.
- New Zealand investment, in property for example, is being significantly influenced by tax effects.
- The system encourages complex structures and distorted investment choices to minimise the tax people pay. This reduces tax revenue for government (which can mean higher public debt or higher revenue having to be raised elsewhere), and it reduces the progressivity of the tax system, with actual tax paid being determined less by ability to pay than ability to arrange one's financial affairs.

- The lack of coherence and integrity increases the costs of administering the tax system. This risks losing public confidence in the system and increases the risk of non-compliance.
- These factors threaten the sustainability of the tax revenue base.

These features are not necessarily unrelated. For example, opportunities to divert income and unfair features of the system can increase the costs of administering the tax system, impact on the efficient allocation of resources and economic efficiency, and can also impact on the sustainability of the tax revenue base. As a consequence, it has been important that the TWG focus on the tax system as a whole.

As the Group has considered options for reform of the tax system it has attempted to measure all possible changes against their effects on fairness and efficiency. It has focussed on considering reform that will collect the revenue that government needs to finance its spending in the least damaging way. The TWG has also recognised the constrained fiscal environment New Zealand currently faces and the profile of future government budget deficits and public debt mean that any tax reform package has to be fiscally neutral. Significantly lower overall tax rates are only possible in the short-run by increasing public debt and in the long-run by reducing the level of government expenditure as a proportion of total New Zealand production and incomes.⁶⁴

In considering reform options, it is also important to recognise that the world economy has changed significantly since the last comprehensive change to the tax system in 1987. The more globally connected world economy means that countries now compete more vigorously over tax policy and tax rates and this is leading to a shift in emphasis on what is sensible to tax, and the general mix of taxes that make up a country's tax base. International research on the evidence about which taxes are more damaging for growth has advanced considerably since the late 1980s and insights from this research have influenced our views about options for reform.

The TWG has not had the time, or the brief, to design in detail a new tax system. But it has attempted, in looking at various issues and tax types, to think of workable options for system-wide reform that the Government should consider. Its objective has been to set out options for a tax system that will boost the efficiency of savings and investment decisions and provide people better reward for working, spread the tax base more fairly, and be easier to comply with and cheaper to administer. It has been this system change that has been the Group's major focus.

The public interest in the TWG's work and the sensible discussion and debate of tax policy that has been occurring means that the Government has the opportunity to set out a longer-term strategy for a sustainable tax system. This will require changing the tax mix and broadening the tax base.

4.2 There are choices around taxation reform

There are a number of options for reform. These options include choices between a system that aligns personal, corporate and trustee tax rates or a system that enables a coherent system of non-aligned rates and facilitates the different choices that a non-aligned system can provide. They include

choices over base-broadening options, and also choices over options that enable the Government to attach a priority to greater certainty over future tax rates and the structure of the tax system. The consequences for efficiency and growth, equity and fairness, administrative and compliance costs, and the sustainability of the tax system will differ across these options.

Two major options for consideration are: an aligned system, where the top personal, company and trust rates are the same; or to make adjustments so that the current non-aligned system has much better coherence and integrity.

Alignment will overcome many integrity problems with the current tax system, and is likely to improve the integrity and sustainability of a system that contains imputation and does not have a comprehensive capital gains tax. Alignment at lower rates across a broader base is desirable. Maintaining alignment will be subject to pressure from falling company tax rates as a result of international tax competition, especially for international capital.

There are sound efficiency reasons to reduce the top personal tax rate, especially in view of the effect on entrepreneurship, competition for skilled labour (in particular with Australia), and the effect that lower personal tax rates will have on lowering the impact of the abatement of WfF on effective marginal tax rates. Alignment that involves a lower top personal tax rate also improves horizontal equity through improved integrity. This is because all equivalent income is taxed at the same rate. However, the effect is to reduce the progressivity of the tax system somewhat (across personal tax rates) unless it is funded in a way that restores progression by changes to existing taxes or by broadening the tax base. This effect is accentuated the lower the rate of alignment.

However, the trend of global corporate tax rates, and particularly the Australian corporate tax rate, will have a significant bearing on the preferred option for reform. Many countries already have, or are now suggesting, future corporate rates that are well below New Zealand's rate, with an implicit view that these lower corporate rates could mean higher personal rates or higher tax rates elsewhere. For small economies, corporate tax rates higher than those that prevail in larger neighbouring countries tend to be costly, and hence there is a tendency for small economies to have lower corporate tax rates.

This changed international context is a major difference when looking at alignment now compared to when it was first introduced in 1988. At that time, New Zealand's tax rates could be set, to a large extent, in isolation from the world. Also, the corporate tax rate of 33% and the top personal income tax rate of 33% were very low internationally. Today, tax is internationally more competitive, and alignment at 30% would leave our corporate tax rate high internationally and probably means that alignment at higher rates is problematic.

In this type of international tax environment, Governments may prefer a system that preserves the viability of following the trend of the last two decades of lower global corporate tax rates while retaining higher personal and other tax rates.

A system of non-aligned rates offers this type of flexibility provided significant other reforms are introduced at the same time to restore and maintain coherence, integrity and sustainability of the tax bases. The more the system is misaligned, the more challenging it is to maintain integrity of the tax system and non-alignment will require new tax structures and tax rules.

The TWG considers that within an aligned or non-aligned system, the efficiency, integrity and fairness of the New Zealand tax system can also be improved by broadening the tax base. Furthermore, in addition to the option of raising the rate of GST, which raises revenue along with improving the efficiency of the tax system, base broadening also provides opportunities to fund reform in a fiscally sustainable manner. The major base-broadening options considered by the Group were:

- Capital gains tax.
- Land tax.
- Risk free return method (RFRM) on residential investment property.
- Denying depreciation on buildings.
- Removing the depreciation loading.
- Reducing the thin capitalisation threshold applying to foreign investment.

As a basis for considering various options to reform the tax system, the TWG evaluated a range of scenarios that involved either alignment or non-alignment of the corporate and top personal income tax rates together with some combination that involved changes to GST or base broadening options. These scenarios were developed to illustrate the likely implications of various options, and the trade-offs in terms of terms the principles of a good tax system.

For illustrative purposes, we comment on two scenarios. A fuller range of scenarios is available from the TWG background papers and an illustration of their application to the consideration of tax policy reform options is available in Nightingale (2009).⁶⁵ The two scenarios discussed here are alignment of the top personal, trust rates and corporate rates at 27% and a non-aligned option where these rates are set at 33% for the top personal and trust rates and 27% for the corporate rate.

Costing of these scenarios has been undertaken on a static basis; that is the calculation of the tax change before the effects of behavioural responses have been taken into account. Reducing tax rates, broadening the base and increasing the integrity and efficiency of the tax system should reap economic and behavioural dividends (growth, productivity improvements and less tax avoidance) that may mean that the fiscal cost of tax reductions is less than the static analysis.

Alignment at 27% has an estimated fiscal cost of \$3.1 billion (in terms of 2009/2010 prices and economic activity). This could be funded from, for example, a capital gains tax (once in steady state), estimated to raise \$3.9 billion, excluding gains on owner-occupied property.⁶⁶

The effect of alignment at 27% would be to:

- Increase the disposable incomes of those at the top of the income distribution.
- Reduce the progressivity of the system by lowering only the top personal rates, although it does not make absolute poverty worse.
- Increase the integrity of the system, by allowing fewer opportunities for avoidance and arbitrage through different entity forms, and consequently have positive administration, horizontal equity, and efficiency impacts.
- Reduce the adverse effects of the structure of the tax system on efficiency and economic growth as a result of the fall in the top personal rate, and the fall in the company tax rate.

In conjunction with alignment at 27%, the introduction of a capital gains tax on all property (excluding owner-occupied), would:

- Increase the tax burden on those on higher incomes, as (with the exception of owner-occupied property) wealth is distributed progressively.
- Further increase the integrity of the system, by including a currently untaxed form of income in the tax base.
- Promote the efficiency of the system by removing distortions in investment incentives created by the preferential treatment of some assets (including rental property). However, any lock-in effects from the capital gains tax would reduce this efficiency benefit.

As Table 3 in Chapter 3 illustrates, there are other base broadening options that could be applied to deliver the revenue required to fund alignment at 27%, but their effects vary. The removal of the depreciation loading will primarily impact on the business sector, and some residential property owners, by increasing their average tax rates. As discussed in Chapter 3, removal of depreciation on buildings and the depreciation loading would improve resource allocation. This would potentially be offset by the reduction in the corporate and personal tax rates. The land tax would affect those who own land at the time the tax is introduced, due to its impact on property values, and will disproportionately impact on extensive landholders, and retirees.

The second illustration, a non-aligned system set at 33:33:27, would have a fiscal cost of approximately \$1.1 billion. This could be funded, for example, by the removal of building depreciation and the removal of the depreciation loading.

A partially non-aligned system set at 33:33:27:

- Would reduce the progressivity of the tax system for similar reasons to the aligned options, but to a much lesser extent.
- Would need to be supplemented by measures to prevent sheltering of incomes in companies.

- Would be likely to have smaller efficiency and growth benefits arising from the fall in the top personal rate.
- Could provide a transition point to a number of options, including alignment at 27%, a lower non-aligned or classical system, or a dual system.

In conjunction with the 33:33:27 option, denying building depreciation and removing the depreciation loading would have an uncertain impact on equity, but would partially offset the tax benefits to corporates arising from the decrease in the statutory corporate tax rate. Similarly, denial of building depreciation would impact the effective average tax rate on residential investment property owners. In addition to funding the tax rate reductions, the depreciation changes would also have efficiency benefits through ensuring the tax treatment of buildings over their lifecycle more closely matches their economic value.

Any changes to the corporate and personal rates for efficiency and growth, or equity reasons, will have a fiscal cost which will need to be funded through base broadening or other revenue raising options if the tax reform is to be fiscally neutral. Base broadening measures will affect the final package chosen in several ways. They provide additional revenue to fund the package. They are important for sustainability reasons, and will improve fiscal integrity, horizontal equity, and have some impact on efficiency. Generally (with the exception of an increase in GST), they will improve the progressivity of the package, although each base broadening option will have particular impacts on certain groups.

4.3 A way forward

A good tax system should minimise uncertainty over future tax rates and the future application of tax bases. This requires that there is a degree of assurance that the tax base will provide revenue adequacy now and in the future. To achieve this property, the tax system must be both economically sustainable and politically sustainable. To be economically sustainable, New Zealand's tax base will need to be less reliant on taxes that are more damaging to growth and on internationally mobile factors such as the incomes of capital and skilled labour.

Political sustainability will require that the tax system be designed to minimise vulnerability to interest group pressure and political temptation to tamper with or reverse the critical elements of a coherent system. Piece-meal changes to the tax system have undermined the integrity, acceptability and political sustainability of the system. It is important to bear this lesson in mind when considering the scope of personal tax rate reductions, increases in GST and base-broadening options.

The TWG considers that the broad-base low-rate option is generally a sound principle to adopt in choosing the approach to tax design and should continue to be an underlying framework for the New Zealand tax system. It is also the trend in other developed countries, where, for the most part, there has been a move towards lower tax rates and wider tax bases.

Nevertheless, the approach of taxing those tax bases that are least likely to be subject to significant behavioural change from the imposition of a tax ('inelastic' bases) is also a sound principle to adopt when choosing between alternative tax bases to facilitate broadening the tax base and lowering rates.

In considering how to balance the principles of a good tax system and ensure that New Zealand has a sustainable world class tax system for the future, the Group focussed on a number of key questions:

- What are the costs and benefits of aligned and non-aligned systems?
- What changes should be made to the company tax rate?
- Should New Zealand retain its imputation system?
- What changes should be made to personal tax rates?
- What are the pros and cons of increasing GST?
- Should base-broadening measures be considered and if so, which options are favoured?
- What changes could be made to resolve the current problems with high effective marginal tax rates?

An aligned system helps overcome integrity problems by removing opportunities for tax structuring. However, it may sacrifice progressivity unless funded in a way that restores the progression of the tax system. Moreover, for a small open economy alignment may not be sustainable given the downward pressure on company tax rates around the world. However, experience in New Zealand during the last decade in particular has shown that a non-aligned tax system requires more robust and coherent tax rules in order to achieve a tax system that has integrity and is fair. In particular, measures to buttress the separate rates, such as a surcharge on the after-tax investment income of closely held companies, measures to tax the capital gain on shares at full personal marginal tax rates, and measures to ensure trusts are taxed at the top personal tax rate would be required.

Most members of the TWG consider that the top personal, trust and company rates should be aligned. If at any time this is no longer feasible due for example to global pressures causing the company rate to reduce, at the very least the trust, top personal tax rate and top rates for PIEs and other widely-held savings vehicles need to be aligned to address integrity, efficiency and fairness concerns.

The TWG considers that New Zealand's company tax rate needs to be competitive with global corporate tax rates, particularly the Australian company tax rate. However, this needs to be balanced against the integrity benefits of a fully aligned system and the fact that reducing the company tax rate will reduce the level of tax on economic rents earned from foreign investments, to the extent these exist. We recommend that officials be requested to undertake further research on this complex interface. There was discussion by the Group about stratifying the company tax base. However, the Group consider that much more work would be required on the implications of this approach before it could be seriously considered.

Critical to the Government's choice between an aligned and non-aligned system will be recommendations of the Australian Taxation Review (especially in respect of the Australian corporate tax rate), the expected future changes in international corporate tax rates, and government preferences for the level of personal tax rates. Personal tax rates influence incentives to work and to develop skills, and the attractiveness of New Zealand to skilled New Zealanders working overseas.

The TWG would prefer to have the company rate aligned with trust and top personal rates. However, if due to international pressures this is not possible, then the aim should be to keep the company and other tax rates as closely aligned as possible. The path to reform should ensure it is feasible to achieve a non-aligned system with integrity in the event alignment proves difficult to sustain.

The TWG also supports the retention of the imputation system. However, this may need to be reviewed if Australia decides to move away from its franking credit system.

With respect to personal tax rates, the Group supports reducing the top marginal tax rates of 38% and 33% as part of an alignment strategy. Where possible, the Group would like to see this reduction in personal tax rates occur across-the-board to ensure lower rates of tax on labour more generally. This could be potentially achieved as part of a package to compensate for any increase in GST.

As part of a redesign of the New Zealand tax system, the TWG considered the pros and cons of increasing GST. The Group concluded that increasing the GST rate would have merit on efficiency grounds because it would result in reducing the taxation bias against saving and investment as against consumption. However, data indicate that while on a life-time basis the incidence of a higher GST seems to be broadly proportional, in terms of current income it tends to be slightly regressive. Also, some people would be particularly disadvantaged by a higher GST rate. As a result, the TWG recognises that any increase in the GST rate would need to be accompanied by measures to offset adverse equity implications of a rise in GST. These measures would significantly reduce the net revenue raised from a higher GST.

The TWG considers that any compensation should be by way of increases in benefit levels and reductions in the personal tax scale. The Group rejected the idea of exempting certain categories of items from GST. Narrowing the GST base (for example by exempting food) would substantially reduce the efficiency of the tax and increase compliance and administration costs, while having limited impact on equity. There were mixed views within the Group as to whether the efficiency benefits from increasing GST would be sufficient to outweigh possible equity effects.

Base-broadening is important to improve the efficiency of the tax system and is essential for funding if there are to be significant reductions in corporate and personal tax rates to achieve alignment or near alignment of rates. The base-broadening measures considered focused primarily on the taxation of capital. Although New Zealand has a general "broad-base, low-rate" framework for taxation, a component of economic income is either not taxed or is taxed inconsistently.

The most comprehensive option for base-broadening, with respect to the taxation of capital, is for New Zealand to introduce a comprehensive capital gains tax. While the comprehensive nature of this

option is seen as attractive and therefore its introduction is supported by some, most members of the TWG are concerned about the practical challenges and efficiency implications of introducing a CGT. These issues include the lock-in effects that can result from a realised CGT and the inherent complexity of a CGT.

A key concern with a CGT is the treatment of owner-occupied housing. If comprehensive base-broadening is pursued through the introduction of a CGT, then in principle owner-occupied housing should be within the CGT base. However, the Group recognises that this is unlikely to be the case as evidenced by the exemptions which operate in other jurisdictions. Introducing a CGT that excludes owner-occupied housing would create a new bias in the tax system.

The other approach to base broadening is to identify gaps that exist in the current system where income is being derived and systematically under-taxed (such as returns from residential rental properties) and apply a more targeted approach. A number of potential options were considered.

Some members of the TWG are attracted to applying a risk-free rate of return method to tax returns from capital invested in residential rental properties. However, it was noted that there are a number of complex design issues that would need to be addressed with this option.

Most members of the TWG support the introduction of a low-rate land tax as a means of funding tax rate reductions and improving the overall efficiency of the tax system. However, there are concerns over the political sustainability of such a tax.

Targeted options for which there was a general consensus, included a range of measures to broaden the tax base by amending the existing tax system. These measures include:

- Removing the 20% depreciation loading on new plant and equipment.
- Removing tax depreciation on buildings (or certain categories of buildings) if empirical evidence demonstrates that they do not depreciate in value over time.
- Reducing the debt leverage allowed under the thin capitalisation rules applicable to foreign investment into New Zealand by reducing the safe harbour threshold to 60% or reviewing the base for calculating this measure.

Another area of reform considered by the TWG is the impact of welfare policy on the tax system, in particular the way in which the Working for Families scheme has impacted on effective marginal tax rates and complicated the system. There are also concerns about whether the equity objectives of WfF were being achieved. The Group strongly recommends a comprehensive review of welfare policy and how it interacts with the tax system be carried out.

In addition to the conclusions summarised above, the Group recommends that serious consideration be given by Government to how institutional arrangements pertaining to tax policy can be improved to ensure a stronger focus is given to achieving and then sustaining the coherence, integrity, efficiency and greater fairness of the New Zealand tax system.

Tax Working Group Background Papers

Frameworks to guide tax reform and current challenges

- TWG Scope and Objectives
(<http://www.victoria.ac.nz/sacl/cagtr/twg/scope-objective.aspx>)
- The New Zealand Treasury; *Estimating the Distortional Costs of Income Taxation in New Zealand*
(<http://www.victoria.ac.nz/sacl/cagtr/twg/Publications/5-estimating-the-distortional-costs-of-income-taxation-in-newzealand-treasury.pdf>)
- Creedy, J; *The Distortional Costs of Taxation*
(<http://www.victoria.ac.nz/sacl/cagtr/twg/Publications/5-the-distortional-costs-of-taxation-johncreedy.pdf>)
- Creedy, J; *The Elasticity of Taxable Income: A Non-Technical Summary*
(<http://www.victoria.ac.nz/sacl/cagtr/twg/Publications/5-the-elasticity-of-taxable-income-johncreedy.pdf>)
- Population Ageing and Taxation in New Zealand
(<http://www.victoria.ac.nz/sacl/cagtr/twg/Publications/Population-Ageing-Taxation.pdf>)
- Presentation by Secretary to the Treasury
(<http://www.treasury.govt.nz/publications/media-speeches/speeches/fiscalframework>)

Tax and Transfers

- Design of the Income Tax/Transfer System: Background paper for the Tax Working Group
(http://www.victoria.ac.nz/sacl/cagtr/twg/Publications/taxes_transfers.pdf)

GST

- *Changing the Rate of GST: Fiscal, Efficiency and Equity Considerations.*
(http://www.victoria.ac.nz/sacl/cagtr/twg/Publications/GST_paper.pdf)

Base broadening – taxation of capital income

- Burman, L & White, D; *Taxing Capital Gains in New Zealand: Assessment and Recommendations*
(http://www.victoria.ac.nz/sacl/cagtr/twg/Publications/3-taxing-capital-gains-burman_white.pdf)
- Policy Advice Division of the Inland Revenue Department and by the New Zealand Treasury; *The taxation of capital gains*
(http://www.victoria.ac.nz/sacl/cagtr/twg/Publications/3-taxation-of-capital-gains-ird_treasury.pdf)
- Coleman, A; *The Long Term Effects of Capital Gains Taxes in New Zealand*
(<http://www.victoria.ac.nz/sacl/cagtr/twg/Publications/3-long-term-effects-of-cgt-coleman.pdf>)
- Policy Advice Division of the Inland Revenue Department and by the New Zealand Treasury; *Other base broadening and revenue raising ideas*
(http://www.victoria.ac.nz/sacl/cagtr/twg/Publications/3-other-base-broadening-ird_treasury.pdf)

- Hargreaves, D; Reserve Bank of New Zealand; *The tax system and housing demand in New Zealand*;
(<http://www.victoria.ac.nz/sacl/cagtr/twg/Publications/5-the-tax-system-and-housing-demand-in-newzealand-reservebank.pdf>)

Base broadening – land taxes

- Coleman, A & Grimes, A; *Fiscal, Distributional and Efficiency Impacts of Land and Property Taxes*
(http://www.victoria.ac.nz/sacl/cagtr/twg/Publications/3-impacts-land-property-taxes-coleman_grimes.pdf)
- Policy Advice Division of the Inland Revenue Department and by the New Zealand Treasury;
Land Tax
(http://www.victoria.ac.nz/sacl/cagtr/twg/Publications/3-land-tax-ird_treasury.pdf)

Company tax

- Policy Advice Division of the Inland Revenue Department and by the New Zealand Treasury;
Company tax issues facing New Zealand
(http://www.victoria.ac.nz/sacl/cagtr/twg/Publications/4-company-tax-_issues-facing-nz.pdf)
- Policy Advice Division of the Inland Revenue Department and by the New Zealand Treasury;
Debt and equity finance and interest allocation rules
(<http://www.victoria.ac.nz/sacl/cagtr/twg/Publications/4-debt-and-equity-finance-and-interest-allocation-rules.pdf>)

Scenarios

- Tax Working Group; Summary
(<http://www.victoria.ac.nz/sacl/cagtr/twg/Publications/session5-summary.pdf>)
- Scenarios: Background paper for the Tax Working Group
(<http://www.victoria.ac.nz/sacl/cagtr/twg/Publications/scenarios.pdf>)

Endnotes

- 1 For further information, see *Estimating the distortionary costs of taxation in New Zealand*, The Treasury, at <http://www.victoria.ac.nz/sacl/cagtr/twg/Publications/5-estimating-the-distortionary-costs-of-income-taxation-in-newzealand-treasury.pdf>. Domestic taxes are a transfer but impose costs via deadweight losses for New Zealand. This is not the case for taxes on foreigners.
- 2 *Challenges and Choices: New Zealand's Long-Term Fiscal Statement*, The Treasury, at <http://www.treasury.govt.nz/government/longterm/fiscalposition/2009>.
- 3 Ramsay, F. (1927), "A contribution to the theory of taxation", *The Economic Journal*, 37, pp. 47-61.
- 4 Furthermore, this conclusion does depend on the design of the tax system. For instance, Atkinson and Stiglitz (1976) point out that under a progressive tax system and certain preference structures, even in theory it may be preferable to have uniform consumption taxes. Atkinson, A. and Stiglitz, J., (1976), "The Design of Tax Structure: Direct versus Indirect Taxation", *Journal of Public Economics*, 6.
- 5 Creedy, J.(2009), *The distortionary costs of taxation*, at <http://www.victoria.ac.nz/sacl/cagtr/twg/Publications/5-the-distortionary-costs-of-taxation-johncreedy.pdf> and also see Creedy, J. (2003), *The Excess Burden of Taxation and Why it (Approximately) Quadruples When the Tax Rate Doubles*, New Zealand Treasury Working Paper 03/29, pp. 26, at <http://www.treasury.govt.nz/publications/research-policy/wp/2003/03-29>.
- 6 See for instance Budget 1984 documents.
- 7 Johansson, A., Heady, C., Arnold, J., Brys, B., Vartia, L. (2008), *Taxes and Economic Growth*, OECD Working Paper 620, at <http://ideas.repec.org/p/oec/ecoaaa/620-en.html>.
- 8 For further information, see Burman, L., and White, D., *Taxing Capital Gains in New Zealand: Assessment and Recommendations*, at http://www.victoria.ac.nz/sacl/cagtr/twg/Publications/3-taxing-capital-gains-burman_white.pdf.
- 9 Peter, K., Buttrick, S., and Duncan, D. (2007), *Global Reform of Personal Income Taxation, 1981-2005: Evidence from 189 Countries*, International Studies Program Working Paper 07-21, Andrew Young School of Policy Studies, Georgia State University, pp. 42.
- 10 *OECD Economic Surveys 1999-2000: New Zealand*. The 2001 Tax Review also considered that the New Zealand tax system was sound. McLeod, R., Patterson, D., Jones, S., Chatterjee, S., and Sieper, E. (2001), *Tax Review 2001*, at <http://www.treasury.govt.nz/publications/reviews-consultation/taxreview2001>.
- 11 See for instance Budget 1984 documents.
- 12 For further information, see *Briefing for the Incoming Minister of Revenue - 2008*, Inland Revenue, at http://www.beehive.govt.nz/sites/all/files/Revenue_BIM_2008.pdf.
- 13 For further information, see *Other base broadening options*, The Policy Advice Division, Inland Revenue, and the Treasury, at http://www.victoria.ac.nz/sacl/cagtr/twg/Publications/3-other-base-broadening-ird_treasury.pdf.
- 14 See Figure 8. These comparisons do not adjust for the effects of imputation on the effective tax rate for domestic residents.

- 15 Kneller, R, Bleeney, M and Gemmell, N (1999), "Fiscal policy and growth: Evidence from OECD countries", *Journal of Public Economics*, 74, pp 171-190, and Johansson, A., Heady, C., Arnold, J., Brys, B., Vartia, L. (2008), *Taxes and Economic Growth*, OECD Working Paper 620, at <http://ideas.repec.org/p/oec/ecocaaa/620-en.html>.
- 16 *Challenges and Choices: New Zealand's Long-Term Fiscal Statement*, The Treasury, at <http://www.treasury.govt.nz/government/longterm/fiscalposition/2009>.
- 17 *OECD Economic Surveys 1999-2000: New Zealand*. The 2001 Tax Review also considered that the New Zealand tax system was in good shape. McLeod, R., Patterson, D., Jones, S., Chatterjee, S., and Sieper, E. (2001), *Tax review 2001*, at <http://www.treasury.govt.nz/publications/reviews-consultation/taxreview2001>.
- 18 See, for instance, the review of taxation developments and challenges in Tanzi, V. (2008), "The Role of the State and Public Finance in the Next Generation", *OECD Journal on Budgeting*, Vol. 8, No. 2, pp. 27.
- 19 See Endnote 15.
- 20 Lorentz, S (2008), "Corporate taxation in the OECD in a wider context", *Oxford Review of Economic Policy*, Vol. 24, Number 4, pp.639–660.
- 21 Peter, K.S., Buttrick, S., and Duncan, D. (2007), *Global Reform of Personal Taxation, 1981-2005: Evidence from 189 Countries*, International Studies Program Working Paper 07-21, Andrew Young School of Policy Studies, Georgia State University, pp. 42.
- 22 For further information, see Creedy, J., (2009) *The distortionary costs of taxation*, at <http://www.victoria.ac.nz/sacl/cagtr/twg/Publications/5-the-distortionary-costs-of-taxation-johncreedy.pdf>.
- 23 OECD (2009). *Taxation and economic growth: Implementing pro-growth tax reforms*, *OECD Working Paper CTPA/CFA/WP2* (2009) 24. New Zealand ranks 7th in the OECD in terms of the percentage of total taxes collected from corporate, personal and social security taxes.
- 24 Both Australia and New Zealand use a family tax credit system. When these are taken into account the gap between the two countries in 'net tax' paid tends to increase – to between \$4,000 and \$10,000 depending on income, and the number and age of children.
- 25 This Figure does not include the impact of other taxes such as stamp duty and capital gains tax.
- 26 For further information, see *Other base broadening options*, The Policy Advice Division, Inland Revenue, and the Treasury, at http://www.victoria.ac.nz/sacl/cagtr/twg/Publications/3-other-base-broadening-ird_treasury.pdf.
- 27 Location specific rents refers to excess profits associated with using New Zealand resources or from operating in New Zealand and selling to the domestic market.
- 28 For further information, see *Company Tax issues facing New Zealand*, The Policy Advice Division, Inland Revenue, and the Treasury, at http://www.victoria.ac.nz/sacl/cagtr/twg/Publications/4-company-tax-_issues-facing-nz.pdf.
- 29 PIEs will be 0%, 12.5%, 21% or 30% from 1st April 2010.
- 30 This is based on the assumptions that trustee income would have continued to grow at the same rate as beneficiary income if rates remained aligned, and that the growth in trustee income since 2000 is wholly attributable to taxpayers using trusts to shelter income from the 39% tax rate.

- 31 The large spikes at lower income are due to non-tax factors, predominantly transfer payments such as benefits and superannuation.
- 32 This number was obtained from the Household Expenditure Survey (HES), Department of Statistics, New Zealand.
- 33 For more details on Australia's Future Tax System Review, at <http://taxreview.treasury.gov.au/Content/Content.aspx?doc=html/home.htm>.
- 34 For more details, see *Challenges and Choices: New Zealand's Long-Term Fiscal Statement*, The Treasury, at <http://www.treasury.govt.nz/government/longterm/fiscalposition/2009>.
- 35 For more details on this option, see *Company Tax issues facing New Zealand*, The Policy Advice Division, Inland Revenue, and the Treasury, at http://www.victoria.ac.nz/sacl/cagtr/twg/Publications/4-company-tax-_issues-facing-nz.pdf.
- 36 There could still be some bias towards debt in financing by non-residents. For further information, see *Debt and equity finance and allocation rules*, The Policy Advice Division, Inland Revenue, and the Treasury, at <http://www.victoria.ac.nz/sacl/cagtr/twg/Publications/4-debt-and-equity-finance-and-interest-allocation-rules.pdf>.
- 37 Other tax systems, such as a comprehensive business income tax and cash flow tax, and the 'Allowance for Corporate Equity (ACE) system, have been suggested in economic literature. However, they have been implemented rarely, if at all, meaning that it is difficult to fully examine these as practical alternatives for New Zealand.
- 38 For more details on this option, see *Company Tax issues facing New Zealand*, The Policy Advice Division, Inland Revenue, and the Treasury, at http://www.victoria.ac.nz/sacl/cagtr/twg/Publications/4-company-tax-_issues-facing-nz.pdf.
- 39 A change to a classical system is likely to allow a drop in the company tax rate. However, after taking account of some behavioural responses to a lower company tax rate, it is estimated that if this reform is to be revenue neutral, any reduction in the company rate would have to be minor.
- 40 See Endnote 36.
- 41 Sorensen, P.B., and Johnson, S.M. (2009), "Taxing Capital Income — Options for Reform in Australia", Paper presented to the *Australia's Future Tax System Conference*, University of Melbourne, 18-19 June, 2009.
- 42 For further information, see *Scenarios*, The Treasury and the Policy Advice Division of Inland Revenue, at <http://www.victoria.ac.nz/sacl/cagtr/twg/Publications/scenarios.pdf>.
- 43 For further information, see Coleman, A. (2009), *The Long Term effects of capital gains taxes in New Zealand*, Paper to the Tax Working Group at <http://www.victoria.ac.nz/sacl/cagtr/twg/Publications/3-long-term-effects-of-cgt-coleman.pdf>.
- 44 For more details on this option, see *Changing the rate of GST: Fiscal, efficiency and equity considerations*, The Treasury and the Policy Advice Division of Inland Revenue, at http://www.victoria.ac.nz/sacl/cagtr/twg/Publications/GST_paper.pdf.

- 45 For more details on this option, see Burman, L., and White, D. (2009), *Taxing Capital Gains in New Zealand: Assessment and Recommendations*, at http://www.victoria.ac.nz/sacl/cagtr/twg/Publications/3-taxing-capital-gains-burman_white.pdf, Coleman, A. (2009) *The long term effects of capital gains taxes in New Zealand*, Motu Economic and Public Policy Research, Motu Working Paper 09-13, pp. 51, at <http://www.victoria.ac.nz/sacl/cagtr/twg/Publications/3-long-term-effects-of-cgt-coleman.pdf>, and *The Taxation of Capital Gains*, The Policy Advice Division, Inland Revenue, and the Treasury, at http://www.victoria.ac.nz/sacl/cagtr/twg/Publications/3-taxation-of-capital-gains-ird_treasury.pdf.
- 46 “Lock-in” refers to the situation where a realisation-based capital gains tax can create an incentive for tax payers to defer the sale of appreciating assets. The opposite effect can also arise. If losses from capital assets can be offset against other forms of income, taxpayers may choose to sell depreciating assets early to reduce their tax liability.
- 47 For more details on this option, see *Land Tax*, The Policy Advice Division, Inland Revenue, and the Treasury, at http://www.victoria.ac.nz/sacl/cagtr/twg/Publications/3-land-tax-ird_treasury.pdf and Coleman, A., and Grimes, A., *Fiscal, Distributional and Efficiency impacts of land and property taxes*, at http://www.victoria.ac.nz/sacl/cagtr/twg/Publications/3-impacts-land-property-taxes-coleman_grimes.pdf.
- 48 While in principle the expected impact of introducing a land tax would be to reduce the value of land subject to the tax, if introduced as part of a reform of the tax system that involved say reductions in other tax rates (such as corporate and personal rates), these other tax changes could be expected to have some partial offsetting effects. The actual change in land values, which only applies to the land component of property, will also depend on other influences taking place at the time, such as the level of net migration.
- 49 For more details on this option, see *Land Tax*, The Policy Advice Division, Inland Revenue, and the Treasury, at http://www.victoria.ac.nz/sacl/cagtr/twg/Publications/3-land-tax-ird_treasury.pdf and Coleman, A., and Grimes, A., *Fiscal, Distributional and Efficiency impacts of land and property taxes*, at http://www.victoria.ac.nz/sacl/cagtr/twg/Publications/3-impacts-land-property-taxes-coleman_grimes.pdf.
- 50 For more details on this option, see *Other base broadening options*, The Policy Advice Division, Inland Revenue, and the Treasury, at http://www.victoria.ac.nz/sacl/cagtr/twg/Publications/3-other-base-broadening-ird_treasury.pdf.
- 51 McLeod, R., Patterson, D., Jones, S., Chatterjee, S., and Sieper, E. (2001), *Tax Review 2001*, at <http://www.treasury.govt.nz/publications/reviews-consultation/taxreview2001>.
- 52 We note, however, that a type of RFRM applies in the Netherlands on a taxpayer’s net investments, including their principal residence, which may provide some guidance.
- 53 The appropriate method for calculating the risk free rate also requires careful consideration. For example, there are issues concerning the use of “nominal” versus a “real” risk free rate, whether to set the rate each year to reflect changes in the value of risk free returns, etc.
- 54 Refer to the references in Endnote 56 and see also Sandford, C. (1987), “An Annual Wealth Tax – Pros and Cons”, Comments on papers presented at the seminar on *The Taxation of Capital Gains or Wealth Tax*, 10 February 1987, Institute of Policy Studies, Victoria University of Wellington.
- 55 For more details on these options, see *Other base broadening options*, The Policy Advice Division, Inland Revenue, and the Treasury, at http://www.victoria.ac.nz/sacl/cagtr/twg/Publications/3-other-base-broadening-ird_treasury.pdf and *Debt and equity finance and allocation rules*, The Policy Advice Division, Inland Revenue, and the Treasury, at <http://www.victoria.ac.nz/sacl/cagtr/twg/Publications/4-debt-and-equity-finance-and-interest-allocation-rules.pdf>.

- 56 Chen, D., and Mintz, J. (2009), *Capital Taxation in New Zealand: A Review from an International Perspective*, paper prepared for the New Zealand Treasury, pp. 46.
- 57 *Tax administration changes to raise additional revenue over time*, The Policy Advice Division, Inland Revenue, at <http://www.victoria.ac.nz/sacl/cagtr/twg/Publications/3-tax-administration-changes-ird.pdf>, *Other base broadening options*, The Policy Advice Division, Inland Revenue, and the Treasury, at http://www.victoria.ac.nz/sacl/cagtr/twg/Publications/3-other-base-broadening-ird_treasury.pdf, and *Debt and equity finance and interest allocation rules*, The Policy Advice Division, Inland Revenue, and the Treasury, at <http://www.victoria.ac.nz/sacl/cagtr/twg/Publications/4-debt-and-equity-finance-and-interest-allocation-rules.pdf>.
- 58 For further information, see *Design of the Income Tax/Transfer System*, The Treasury and the Policy Advice Division of Inland Revenue, at http://www.victoria.ac.nz/sacl/cagtr/twg/Publications/taxes_transfers.pdf.
- 59 For further information, see *Design of the Income Tax/Transfer System*, The Treasury and the Policy Advice Division of Inland Revenue, at http://www.victoria.ac.nz/sacl/cagtr/twg/Publications/taxes_transfers.pdf.
- 60 Organisational Review Committee (1994), *Organisational Review of the Inland Revenue Department*, Wellington, pp. 77-85 and Appendix G.
- 61 See <http://www.rewriteadvisory.govt.nz/>. The Rewrite Advisory Panel consists of a chairman and representatives from Inland Revenue, the New Zealand Institute of Chartered Accountants and the New Zealand Law Society.
- 62 This idea is more fully developed in Head, J.G., (1997), 'Prolegomena to Fundamental Tax Reform' in R. Krever (ed.), *Tax Conversations: A Guide to the Key Issues in the Tax Reform Debate*, London, Kluwer Law International, pp.19-45. It is 'quasi-constitutional' because it applies for many, successive budgetary decision-making periods: Buchanan, J.M., (1968), *The Demand and Supply of Public Goods*, Chicago, Rand McNally, Ch. 8.
- 63 See <http://www.taxboard.gov.au/content/default.asp>. The Board of Taxation has 10 members, seven of whom (including the chair) are appointed from the non-government sector and three from the public service.
- 64 See pp. 3-5 of Barker, F., Buckle, R.A., and St Clair, R.W. (2008), *Roles of Fiscal Policy in New Zealand*, New Zealand Treasury Working Paper 08/02, pp. 53 for an explanation of the Government Budget Constraint and the relationship between government tax revenue, expenditure and debt, under alternative fiscal rules, at <http://www.treasury.govt.nz/publications/research-policy/wp/2008/08-02/>.
- 65 For further information, see Endnote 42 and see Nightingale, G. (2009), presentation on Scenarios to the Conference on *A Tax System for New Zealand's Future*, at <http://www.victoria.ac.nz/sacl/cagtr/twg/Publications/pm-2b-scenarios-geof-nightingale.pdf>
- 66 This estimate of \$3.9 billion is lower than the estimate shown in Table 3 because in this scenario, the capital gains will be taxed at lower personal tax rates.