

Table of contents

Executive Summary	i
Introduction	1
Chapter One – Frameworks	5
Chapter Two – Tax Bases	27
Chapter Three – Environmental Externalities and Eco-Taxes	69
Chapter Four – Tax Rates	85
Chapter Five – Taxable Entities and their Tax Treatments	111
Chapter Six – International Tax: Taxing Income from Inbound and Offshore Investment	125
Chapter Seven – Savings	167
Annexes:	
Annex A – The Risk-Free Return Method	175
Annex B – International Comparisons	187
Annex C – Overview of New Zealand Taxation of Offshore Investment	196
Annex D – Implementing A Targeted Reduction in the Company Tax Rate for Non-Resident Investors	201
Annex E – Environmental Externality Estimates in Road Transport	205
Annex F – Summary of Submissions	209
Annex G –Terms of reference	215

INTRODUCTION

Our Tax System in Context

Less than 35 years ago, an earlier tax review committee proposed a top marginal tax rate of 75 percent on a 76-step tax scale and concluded that a rate of this magnitude would not unduly dampen incentives to work, save and invest.¹ At the time, taxes represented around 25 percent of all goods and services produced in the economy (GDP).

In the late 1970s, there were 19 steps in the personal tax scale with a top marginal tax rate of 60 percent. The income of companies was taxed at 45 percent and was taxed again in the hands of shareholders at their marginal tax rates. Taxes represented 31 percent of GDP.

New Zealand now has a four-step scale with a top rate of 39 percent and company income is taxed at 33 percent with full crediting of that tax to resident shareholders. Taxes represent some 32 percent of GDP.

This lowering of tax rates, accompanied by an increase in total revenue, has been achieved by significant expansions of tax bases.

Such a significant change in the structure of taxes reflects a widely-shared perspective that in an increasingly open economic and social context, raising revenue through taxes involves significant costs. It also reflects a view, shared by successive governments, that a broadly-based low-rate revenue raising strategy is an appropriate way of lowering those costs, while maintaining and promoting fairness.

But that consensus has taken some time to emerge. Most successful reforms of enduring benefit as mainstays of New Zealand's current tax system generated controversy at the time they were introduced. Much of the impetus for those reforms can be traced to the reports of review and consultative committees like that referred to in the opening paragraph. Without exception, those reports are examples of dispassionate, rigorous and independent analysis of the complex issues faced in seeking ways to reduce the costs to the community of raising tax revenue consistent with wider social goals.

Like our predecessors, we have grappled over the last few months with inescapable trade-offs among competing objectives that defy neat solutions. And also like our predecessors, we

¹ Taxation Review Committee (the Ross Review), 1967, *Taxation in New Zealand: Report of the Taxation Review Committee*, Wellington, New Zealand.

expect some of our (albeit preliminary) findings to provoke vigorous debate. But drawing on our diverse backgrounds and perspectives, we have endeavoured to let the available evidence and contemporary analysis speak for itself, even if the inferences we draw challenge established conventions. After all, if those conventions provided an adequate basis for future policy, the broad-ranging task we have been given would be unnecessary.

We have drawn heavily on submissions in preparing this report, and we look forward to further submissions that rigorously test our analysis and the evidence upon which it is based. The future prosperity and welfare of New Zealand requires an open and informed debate of the issues raised in our terms of reference.

We have adopted a medium-term perspective in considering what makes a good tax system and how the current New Zealand tax system stacks up. We have also had regard to the tax system as a whole and how its components (such as income tax, consumption taxes like GST and excise taxes) interact with each other. New Zealand's openness to the rest of the world and the need to attract high quality skills and investment are very relevant in this context.

This issues paper does not contain our final conclusions. The purpose of the issues paper is to present what information we know and the direction of our analysis on key issues. This should provide a clearer foundation for more focused submissions.

Structure of this Issues Paper

The paper is structured as follows:

Chapter One	Discusses the role of frameworks in tax policy, and outlines the analytical framework we have applied in the remainder of the paper
Chapter Two	Looks at tax bases; the things that New Zealand currently taxes and might tax in the future
Chapter Three	Examines one topical and self-contained issue: 'eco-taxes', taxes designed to improve the environment as well as raise revenue
Chapter Four	Completes the other side of the tax story: tax rates, with the main emphasis being on the appropriate rate of tax on personal income and company tax
Chapter Five	Moves the discussion into business tax, and outlines how the different forms of business entities should be taxed
Chapter Six	Looks at international tax: how New Zealand should tax income that crosses international borders
Chapter Seven	Deals with the taxation of savings.

The various annexes to the paper contain the details of some issues that are addressed in general terms in the individual chapters.

Submissions

This issues paper is an important milestone in our work, but it is by no means the end of our task. The next stage of our work is seeking feedback from the New Zealand community about the issues we discuss. Have we got it right? What have we missed? But above all: is the big picture right? Do the various parts of what we are proposing hang together?

Written submissions can be made now and up to 5:00pm on 1 August 2001. They can be sent to:

The Secretary
Tax Review 2001
PO Box 3724
WELLINGTON

or info@taxreview2001.govt.nz

Submissions in electronic form are preferred. Where possible, all submissions will be made public on our website unless otherwise requested.

CHAPTER ONE FRAMEWORKS

In this chapter, we review the principles that should guide tax reform. In broad terms, our preliminary views are that:

A framework of tax policy principles is needed to guide the reform of a complex tax system and to avoid *ad hoc* changes. The absence of a coherent approach to tax policy makes for instability and uncertainty.

The key focus of tax policy is to enhance the overall economic well-being of New Zealanders by seeking ways to reduce the costs of imposing taxes – or making the tax system more efficient – while promoting fairness and continuing to raise sufficient revenue.

Tax design should be guided by generally accepted principles of fairness, namely that people in the same position should be treated similarly, that people should contribute in accordance with their ability to pay, and that tax reform should be transparent and prospective.

It is important in assessing both fairness and efficiency to appreciate who actually pays a tax. The legal incidence, the person who pays the Inland Revenue Department, can be different from the person who faces the economic burden. It is the economic incidence, not the legal incidence, that determines the true impact of a tax.

Taxes will generally impose economic costs, because they induce individuals to make decisions that they would not have made in the absence of the tax. At its broadest, excess burden includes the costs of misallocating scarce economic resources, tax administration by government and tax compliance by taxpayers.

Greater mobility of skilled labour and financial capital means the economic costs of taxes are higher than they were previously, for any given tax rate. Greater mobility also makes it increasingly likely that taxes on skilled labour and financial capital will be shifted onto others, including people without internationally marketable skills and landowners.

In some instances the government will wish to use the tax system as a means of deliberately adjusting behaviour. As a general principle, we believe there should always be a strong presumption against extending concessionary treatment to any particular activity or sector, whether the concession is advocated on grounds of international competitiveness or for other reasons.

Broad-based taxes that are expressed simply and clearly in legislation and that enable rates to be as low and as uniform as possible reduce both the opportunity and incentives for avoidance.

How tax policy is developed is also important. The current generic tax policy process, while having many desirable features, could be improved.

Introduction

- 1.1 Annual tax revenue currently equates to around 32 percent of all the goods and services produced in New Zealand (GDP). Collecting taxes on this scale means the tax system affects practically every decision made by New Zealanders, including decisions about workforce participation, undertaking education and training, making savings or investments, or where to live. It is necessary to understand how taxes affect these kinds of decisions both to assess the effectiveness of the tax system and to assess the respective merits of alternative proposals for change.
- 1.2 People generally react negatively to a tax, particularly if it falls upon them. A common reaction to any tax is to point to its obvious damaging effects. But at the margin of a tax system, reduced taxes in one area simply means more taxes in another. Governments have the unenviable task of weighing the relative costs of competing tax measures and cannot focus only on the absolute costs of any particular measure. Similarly, an objector to any particular tax should be obliged to identify how any revenue loss should be made up.
- 1.3 A framework of tax policy principles is needed to guide the reform of a complex tax system and to avoid *ad hoc* changes. The absence of a coherent (and preferably widely-understood and accepted) approach to tax policy makes for instability and uncertainty. We therefore focus in this chapter on establishing a general approach (or framework) to tax policy issues.
- 1.4 In the process, we draw heavily on the insights of economic analysis and the experience of New Zealand and other countries. But while it is appropriate to learn from the experience of other countries, this does not mean *do as others do* or *do what has been done before*. New Zealand's tax system must reflect its own social, economic and cultural objectives and institutions.
- 1.5 The main purpose of the tax system is to fund government spending. However, some taxes are designed primarily to pursue other social or economic outcomes rather than to raise revenue. We refer to these other taxes as 'corrective taxes' in contrast to mainstream 'revenue taxes'. In broad terms, the key focus of tax policy is to enhance the overall economic well-being of New Zealanders by seeking ways to reduce the costs of imposing taxes – or making the tax system more efficient – while promoting fairness and continuing to raise sufficient revenue.
- 1.6 A conventional approach to setting tax policy is to focus separately on the two objectives of making the system fairer and more efficient. We follow this approach in this chapter. We begin with a discussion of fairness, noting that while people will not always fully agree on what constitutes a *fair* system, it is possible to identify several tests that most people would agree a tax system must satisfy if it is to be considered fair. We also note that fairness is inextricably linked with the question of who actually bears the consequences of a tax – the economic impact of a tax will often be different from its statutory impact.

- 1.7 Assessing the impact of changes to the tax system requires some understanding of the nature of the economic costs (and benefits) that taxes might give rise to. Our discussion of the efficiency effects of taxes therefore includes some discussion of the relevant economic concepts. We also discuss trade-offs between different aspects of efficiency and equity. Lowering the costs of the tax system in one direction may result in a higher cost elsewhere. Likewise, lowering the economic costs of the tax system may compromise the government’s fairness goals.

Questions we’d like you to consider

- (a) Do you agree that it is important that there is a general approach to the analysis of tax policy issues that is widely understood and accepted?
- (b) If so, do you agree with the general approach adopted by the Review in this chapter?
- (c) If you don’t agree with specific elements of the framework set out in this chapter, but believe a generic framework is important, what are the elements you consider should be included in a framework to integrate and analyse the effects of the tax system in furthering the government’s goals?

- 1.8 New Zealand cannot set tax policy in ignorance of other countries’ tax systems or the effects of a rapidly changing global economy. We live in a small country with a high reliance on foreign capital and an increasing reliance on skilled labour. It is therefore critical that we understand both how taxes affect the willingness of non-residents to invest or reside in New Zealand and the effects taxes have on New Zealanders’ decisions about whether to invest or reside here or overseas. In addition, tax policy cannot be set without regard to practical constraints in the design of tax legislation.
- 1.9 It will generally be both unfair and inefficient to apply different tax rates to different activities. Sometimes, however, taxes are advocated that are explicitly intended to hit some activities more heavily or lightly than others, as a means of correcting for ‘externalities’. While we defer much of our discussion on this topic until Chapters Two and Three, we do elaborate in this chapter on the circumstances in which selective tax incentives might be pursued.

Fairness

Principles

- 1.10 The concept of fairness is inherently subjective. People usually disagree about who should pay tax, and how much they should pay relative to others. However, there are four general principles of fairness that are usually considered in setting tax policies:

- ***ability to pay.*** Under this principle, the tax system should reflect differences in ability to pay. Both a proportional tax scale (under which a constant proportion of income is levied as tax regardless of income) or a progressive tax scale (under which the proportion of income paid as tax increases with higher income) are consistent with the principle of ability to pay depending on normative views about the appropriate distribution of income. It is a common, though not universal, presumption that ‘vertical equity’ requires that tax burdens be distributed at least somewhat progressively on the grounds that the tax system should help narrow the dispersion of the distribution of after-tax incomes;
- ***even handedness.*** The concept of even-handedness aligns with an established principle of ‘horizontal equity’, which holds that people in the same economic position should bear the same tax. While this principle seems obvious, it can often be difficult to apply in practice, since it is unusual to find two people who are in exactly the same economic position. For example, even where two people have the same income, they will often face different family responsibilities;
- ***user pays.*** The principle of user pays aligns with the so-called ‘benefit principle’, which holds that taxes should be allocated in accordance with benefits (government expenditure) received. This principle is, however, relatively limited as a guide to tax policy. First, it is not possible to identify the primary beneficiaries of many government expenditures, such as national defence. Secondly, much government expenditure is specifically designed to redistribute income toward families and individuals with specific needs or at particular times in their life (such as when they have young families or are retired). Thirdly, much expenditure that is not aimed specifically at redistributing income is not allocated according to tax paid, such as access to education and health care; and
- ***transitional fairness.*** Transitional fairness focuses on the effects and timing of tax reforms. The generally accepted principles are that tax reform should not be retrospective, should minimise windfall gains and losses, and should be open and consultative.

1.11 There is usually a need to make trade-offs between redistributive objectives (or the pursuit of vertical equity) and efficiency objectives. However, the conflict between the objectives of fairness and efficiency can be overstated – the two objectives are often complementary. For example:

- perceptions of fairness are likely to enhance voluntary compliance, which is at the heart of how our taxes are administered, thereby reducing evasion and tax avoidance; and
- the concept of horizontal equity is often – though not always – fully consistent with efficiency (we discuss efficiency concepts further below). Equity and efficiency are both served when income earned by an individual is taxed at the same rate whatever its source and nature.

Determining who pays taxes

- 1.12 The person who is legally required to pay a tax will often differ from the person who actually bears it (that is, the person who sustains the ‘economic incidence’ of the tax). For example, the legal requirement to pay fringe benefit tax is on employers whereas employees face the legal requirement to pay tax on wages (although the employer is legally obliged to deduct PAYE on behalf of the employee). Despite these differences in legal incidence, the economic incidence of fringe benefit tax and PAYE will essentially be identical – the cumulative impact on employees’ after-tax incomes will be the same whether their incomes comprise cash or benefits.
- 1.13 More generally, people have varying abilities to shift some or all of the taxes they are legally obliged to pay onto other people. Taxes might be shifted by way of price increases, changes in wages or changes in behaviour. Example 1.1 provides a simple illustration.

Example 1.1 – *The Economic Incidence of Taxes*

From an initial situation where there is no tax on labour income, the government introduces a proportionate tax rate of 25 percent.

Steve

Steve’s job pays \$12 per hour before tax. Steve’s skills are not in high demand among other employers in his town. Steve is reluctant to move to another town and he has few other income earning options if he chooses to stay. Further, Steve’s employer cannot afford to increase Steve’s wage. On introduction of the tax, Steve’s before-tax income remains at \$12 per hour and his after-tax income falls by 25 percent to \$9. *Both the legal and the economic incidence of the tax fall on Steve.*

Aroha

Aroha, on the other hand, has skills that are in high demand in both New Zealand and overseas, and does not have a deep attachment to the city in which she lives. Aroha’s employer is doing relatively well and is keen to retain Aroha.

Before the tax is introduced, Aroha earns \$30 per hour and is aware she could earn \$25.50 per hour after tax overseas. She makes it clear to her employer that she will leave her job if her after-tax wage in New Zealand falls below this amount.

Accordingly, to ensure that she does not lose Aroha, her employer increases her before tax wage to \$34 when the tax is introduced. Tax at 25 percent reduces this by \$8.50 to \$25.50. While the legal obligation to pay the tax rests fully on Aroha, the economic impact is spread between Aroha (who is \$4.50 worse off than she was before the tax was introduced) and Aroha’s employer (who is \$4 worse off).

1.14 Example 1.1 is clearly over-simplified.² But the point it makes applies in more realistic settings: we will often reach misleading conclusions about the fairness of the tax system if we simply assume that the economic consequences of a tax fall on the people who are legally obliged to pay it. In practice, it is generally difficult to determine precisely the actual incidence of a tax.

However, careful analysis generally enables us to reach a reasonable understanding of how the economic impact of a tax is likely to be shared among individuals in their varying roles as consumers, workers and providers of capital.

1.15 Peoples' ability to shift a tax onto other people will depend on the range of options available to them. In the example, Aroha had more options than Steve, leaving her better placed to shift part of the tax onto her employer.

1.16 Equivalently, taxes will be shifted less if the relevant behaviour of the people on whom they are imposed is relatively unresponsive to the tax. And responsiveness, in turn, will naturally enough depend on peoples' *opportunities* to respond. Suppose, for example, that a tax is introduced on sales of a particular item. If the item does not have close substitutes – say a refrigerator – purchasers will have no opportunity to switch to buying a similar but untaxed item. So it is more likely that sellers will be able to increase the price by the full amount of the tax without seeing much fall off in sales. On the other hand, if a selective tax were introduced on sales of a relatively commonplace item – say a particular type of apple – many consumers would simply switch to similar but untaxed items if sellers tried to increase prices by the full amount of the tax. In this case, most of the tax will be shifted from consumers to sellers, who will in turn have varying abilities to further shift the tax onto, for example, their employees or suppliers.

1.17 People will have more opportunities to respond to taxes in the longer term. It may therefore take some time for the full impact of tax changes on the incidence (and thus the fairness) and efficiency of taxes to unfold. The same point applies to businesses: while imposition of a new tax might not provide cause for scrapping existing capital, in the longer run taxes may lead to capital not being replaced and new investment being diverted elsewhere.

1.18 People, not institutions, bear taxes. Institutions take a variety of forms – such as limited liability companies, partnerships, trusts, superannuation funds and unit trusts – but are all ultimately repositories for funds invested by individuals. While a company, for example, might have a legal obligation to pay a tax, it is the company's shareholders, employees, suppliers or customers who, one way or another, will suffer the economic consequences.

² Simplifying assumptions include the absence of any labour taxes prior to the tax's introduction and the inability of Steve and Aroha's employers to pass the additional tax costs on to consumers through higher prices. The example also ignores 'second-round' effects, such as the reduction in Aroha's employer's taxable income, and hence tax liability, due to the higher wage paid to Aroha.

- 1.19 Fairness considerations suggest that individuals on identical incomes should not pay different amounts in tax if they choose different types of entities as repositories for their savings. We discuss this matter further in Chapter Five, *Entities*, where, among other things, we note that there are significant practical problems in fully achieving this goal.
- 1.20 In some cases, ‘old taxes’ that apparently violate the principle of horizontal equity are in fact fair. Tax preferences – say, a concessionary tax rate on income from a particular activity – tend to become ‘capitalised’ into the market values of assets.

Example 1.2

The government introduces an exemption from tax for interest paid on a particular type of perpetual bond, of which there are a limited number on the market. The bonds have a coupon interest rate of 10 percent. The prevailing interest rate on otherwise comparable bonds that yield taxable interest is 10 percent, and all potential buyers are on a 30 percent tax rate.

Prior to the tax change, a (soon to be) tax-preferred bond with a \$10 coupon would have traded at

$$\frac{\$10 \times (1 - .3)}{.1 \times (1 - .3)} = \$100$$

with taxpayers discounting the after-tax coupon payment of \$7 by their after-tax opportunity cost of capital, 7 percent. The tax change does not affect the discount rate, which reflects returns available from alternative investments, but results in a tax-free coupon payment of \$10. So the bonds will now trade at

$$\frac{\$10}{.1 \times (1 - .3)} = \$142.86$$

A holder of a bond at the time of the change will enjoy a windfall gain of \$42.86, but a subsequent purchaser will be no better off than investors in taxed bonds, since the yield on their investment will be

$$\frac{\$10}{\$142.86} = 7 \text{ percent.}$$

- 1.21 This capitalisation of tax concessions is highly relevant in considering transitional fairness. If, in the example, the government subsequently repealed the concession, the value of a bond would fall by \$42.86 back to \$100, leaving those who had paid the higher price suffering a windfall loss.³
- 1.22 It is consequently important to give full consideration to appropriate transitional rules when tax rules are changed. While it is not possible to fully avoid windfall losses (and gains) in the course of tax reform, windfall losses should where possible be avoided if they would be significant enough to result in hardship or unduly undermine policy or

³ While capitalisation of tax preferences will act over time to make the tax system fairer, it will *not* make the system more efficient. Although preferences will in part result in the price of preferred assets being bid up, they will also result in over-investment in tax preferred activities.

investor certainty. Generous ‘grand-parenting’ rules imposed when a concession is removed also delay efficiency gains from the concession’s removal.

Taxes and New Zealand’s Economic Well-being

The effect of taxes on behaviour

1.23 Taxes can never be raised costlessly. Quite apart from compliance and administrative costs, taxes will generally impose economic costs because they induce individuals to make decisions that they would not have made in the absence of the tax.⁴ These costs (referred to, generally, as ‘excess burden’ or ‘deadweight costs’) can be thought of as the difference between the amount individuals would be willing to pay to avoid having a tax imposed and the net amount of tax collected, after allowing for costs of compliance and administration. This difference will be larger the bigger the tax-induced change in behaviour, as the example below illustrates.

Example 1.3 – *The impact of taxes on behaviour*

Suppose a shop sells 2 kilograms of apples per day at a price of \$2 / kg.

One kg is sold to Joe, who far prefers apples to other fruit, and who would still buy a kg / day even if it cost \$4.

The other kg is sold to Freda, who is indifferent between apples and pears. She buys apples only because they are cheaper than pears, which cost \$2.50 / kg.

The government imposes a tax of \$1 / kg solely on apples, resulting in the price of apples increasing to \$3 / kg.

Due to his preference for apples, even at the higher price of \$3/kg, Joe continues to buy them, but Freda switches to pears. The result is that daily sales of apples fall to 1 kg on which \$1 of tax is raised.

How much would Joe and Freda collectively be prepared to pay not to have the tax imposed?

Clearly, the most Joe is prepared to pay is \$1, the additional amount he is paying in tax. Freda, even though she is not paying any ‘apple tax’, would still be willing to pay up to 50 cents per day – her additional outlay on pears – to avoid having the tax imposed.

Hence, the economic cost of the tax is 50c, which is the difference between the \$1.50 Joe and Freda are prepared to pay to avoid the tax and the \$1 collected in tax revenue.

⁴ The relatively limited circumstances under which taxes can be used to induce *desirable* changes in behaviour are discussed in Chapter Two, *Tax Bases*, and Chapter Six, *International Tax: Taxing Income from Inbound and Offshore Investment*.

1.24 Simple as it is, Example 1.3 illustrates some key principles:

- a tax will not impose economic costs if it does not result in a change in behaviour. If buying apples was so much superior to any other alternative that neither Joe nor Freda changed their purchasing pattern, the amount they were willing to pay to avoid the tax would have been identical to the tax revenue raised;⁵
- more generally, economic costs will be higher the larger the behavioural response. Suppose in the example both Joe and Freda switched from apples to pears. The tax would not have raised any revenue but would have imposed an economic cost of \$1 (Joe and Freda's respective additional outlays of 50c/kg on pears). The term 'elasticity' refers to the extent to which individuals' behaviour changes in response to a change in prices. In this case, the demand for apples is highly price elastic;
- taxes induce a behavioural response when they affect relative prices. In the example, the tax alters the price of apples relative to the price of a substitute - pears. If the tax had been imposed on both apples and pears, it would have been far less likely to induce a change in Joe and Freda's consumption patterns; and
- individuals respond differently to taxes. Where an individual is (close to being) indifferent between two activities in the absence of a tax, and the tax changes the relative price of the activities, the tax will affect the individual's decisions in ways that impose costs. Taxpayers who are 'on the margin' can be regarded as being the most important taxpayers in tax reform because tax rules are more likely to influence their decisions.⁶

1.25 In most real-world settings, the relative price effects of taxes, and taxpayers' differing responsiveness to them, are less obvious than in Example 1.3. But the behavioural effects of taxes are pervasive and give rise to trade-offs that cannot be escaped in setting tax policy. Equity considerations imply that the two individuals in Example 1.3 should face the same tax rates. Promoting efficiency, however, implies that more mobile labour should be taxed more lightly. Examples of other important trade-offs are noted in the table below.

⁵ If buying apples was so much superior to any other alternative, the price of apples could rise without causing Freda or Joe to alter their buying behaviour. The resulting additional revenues represent 'rents' that would be captured by the shop owner in the absence of a tax. A tax would, instead, result in some of the rents accruing to the government. Taxes on rents, *prima facie*, result in few economic costs because revenue is collected with negligible changes in behaviour.

⁶ Taxpayers who are not 'at the margin' (such as Joe, in Example 1.3, because of his strong preference for apples) are less responsive to changes in tax rules. We refer to these taxpayers as 'infra-marginal' taxpayers.

Type of trade-off	Explanation	Examples
Work – leisure	Taxes reduce after-tax income from work (labour). This reduces the amount someone gives up in deciding to pursue leisure rather than work, thereby inducing some people to work less than they would have worked in the absence of the tax. ⁷	Both consumption taxes (like GST) and income taxes levy tax on labour income. Hence both tax bases distort the labour-leisure choice.
Education – leisure	This trade-off relates to the impact of taxes on incentives for people to undertake learning and training (acquiring human capital). The trade-off is closely related to the labour-leisure trade-off. Taxes reduce after-tax income from returns to additional human capital. This reduces the amount someone gives up in deciding to pursue leisure rather than to acquire human capital, thereby inducing some people to undertake less training and learning than they would have in the absence of the tax.	Both consumption taxes (like GST) and income taxes levy tax on income from additional human capital in much the same way. ⁸ Hence both tax bases distort the education-leisure choice.
Consume or save	Taxes on returns to saving have the effect of reducing the ‘price’ of consumption now, when that price is expressed in terms of foregone consumption in the future (see the discussion under “The Revenue Tax” below and Chapter Two, <i>Tax Bases</i>).	Under an income tax, returns on saving are subject to tax. Consequently, a consumption tax does not distort the timing of a person’s saving and consumption decisions.
Invest or save	Taxes on income from capital have either of two effects: <ul style="list-style-type: none"> • they increase the cost of capital to business (thereby suppressing investment); or • they decrease rates of return to savers (thereby suppressing savings). Reducing the investment distortion will increase the saving distortion and vice versa (see the discussion under “International Dimensions” below and Chapter Six, <i>International Tax: Taxing Income from Inbound and Offshore Investment</i>).	The trade-off between investment and savings is relevant in the design of international tax rules, in particular the tax treatment of non-resident investors.
Taxed and non-taxed activities	There will inevitably be a trade-off between seeking to reduce the difference in tax rates between taxed and non-taxed activities and the goals of administrative simplicity and certainty.	These trade-offs arise in considering existing material gaps in the tax base; for example, certain non-taxed capital gains and non-market income such as imputed rental income from owner-occupied housing.

⁷ When considering the efficiency effects of taxes, a distinction is made between two competing effects of an increase in tax. The first is an ‘income effect’, since the tax increase reduces after tax income and so increases the individual’s labour supply in an effort to counter the reduction in consumption. But the tax increase also has a ‘substitution effect’ by reducing the marginal return to work, which leads to a reduction in labour supply. The income effect is merely a transfer from the taxpayer’s pocket to the government. The real efficiency cost is the substitution effect. Hence, when we refer to the responsiveness (or elasticity) of labour supply to changes in taxes, we are focusing on the substitution effects of the taxes.

⁸ To the extent that training is financed from foregone income the person could have earned while training, it is financed, in effect, from before tax rather than post-tax earnings. This is the same effect to that obtained under a consumption tax.

1.26 Later chapters explore ways in which efficiency costs of taxes can be lowered by reducing the severity of the above trade-offs consistent with other goals, such as equity and administrative simplicity. But the above discussion immediately suggests two inter-related general principles:

- differences in effective tax rates between taxed and non-taxed investments/activities should be kept as low as possible. This suggests that tax rates, regardless of the base, should be kept as low as possible; and
- a similar tax treatment should apply to closely substitutable activities/investments. This suggests that the tax base should be as broad as possible (again, consistent with administrative simplicity and certainty goals).

1.27 Economists have applied significant effort over the last 40 years or so to exploring ways of estimating the economic costs arising from the effect of taxes on behaviour. While estimates and methodologies vary, studies invariably conclude that these costs are significant.

1.28 The most recent applicable study⁹ of which we are aware concluded that the excess burden of raising an additional dollar of taxes on labour was, in 1991, 18 percent; while the marginal excess burden of all taxes on consumption was 14 percent.

Other sources of economic cost

1.29 There are other ways taxes impose economic costs, in addition to the costs resulting from taxpayers' behavioural responses. They are:

- administration costs incurred by government. These include the costs of Inland Revenue, the courts and executive and legislative processes;
- compliance costs incurred by taxpayers. Compliance costs include those incurred by taxpayers in obtaining information (including advice), preparing and filing returns, making payments, and resolving disputes. These costs are significantly affected by the detailed design of the tax system; and
- lobbying costs incurred by society. These are costs associated with taxpayers seeking concessions or making representations to avert additional taxes on their activities. Lobbying is legitimate, but consumes resources, such as the time and attention of politicians, lobbyists and senior private sector and government officials, that could be more productively spent elsewhere.

Assessing the effects of taxes

1.30 When a tax base is defined less than comprehensively, taxpayers will be confronted with 'effective tax rates' that may vary across different activities or investments, even if a common statutory rate applies. The concept of an effective tax rate is fundamental to an understanding of how taxes affect behaviour.

⁹ W.E. Diewert and D.A. Lawrence, 1994, *The Marginal Costs of Taxation in New Zealand*, New Zealand Business Roundtable.

1.31 An effective tax rate on income is simply:

$$\frac{\text{Statutory tax rate}}{\text{The proportion of comprehensive income that is subject to tax}}$$

1.32 For example, if the statutory tax rate is 33 percent, but only 80 percent of the economic income from an investment or activity is subject to tax, the effective tax rate is 33% x 80%, or 26.4 percent.

1.33 Effective tax rates will be lower than the statutory tax rate, if only a proportion of economic income is subject to tax. This may be because:

- some income is excluded. For example, while the dividend component of the expected return from shares might be subject to tax, the capital gains component may not be subject to tax; and
- tax rules may result in a deferral of tax. For example, if the gain on an asset is taxed only when it is realised, the present value of the gain that is subject to tax will be less than if that gain was recognised as it accrued (the benchmark for measuring economic income). Tax rules sometimes defer tax because expenditure is recognised in advance of associated revenues.

1.34 Effective tax rates will sometimes exceed the statutory tax rate. The most common reason for over taxation of economic income is because the current tax system does not have regard to measures of real (inflation adjusted) income. As a consequence, the tax system often taxes more than 100 percent of *real income*.

Example 1.4 – Effective Tax Rates on Real Income

Helen purchases for \$100 an interest-bearing bond, which matures in a year's time for \$107.12, including the annual interest component payable at maturity. The bond's before-tax annual yield is therefore 7.12 percent.

Inflation during the course of the year is three percent. The tax rate is 33 percent levied on taxable income measured in a way that does not take account of the effect of inflation in eroding real income.

Helen's income before adjusting for inflation is \$7.12.

Helen's real inflation-adjusted income is \$4 (ie, \$1.0712/1.03 – 1).

Helen's taxable income therefore equates to 178 percent of her economic, or true, income. So the effective tax rate on Helen's interest income is:

$$33\% \times 1.78 = 58.7\%$$

- 1.35 The example above highlights the impact of inflation on effective tax rates. The interaction between inflation, even at historically low levels, and effective tax rates has a number of implications:
- inflation can markedly increase tax rates on savings and investment;
 - the effects of inflation on effective tax rates vary across different types of investment. They are most significant in respect of financial arrangements, which are typically taxed on an accruals basis, and trading stock, which is in effect taxed on an accruals basis because of stock turnover. They are less severe where assets are held for some time before they are sold – by itself, deferral of tax results in lower effective tax rates, offsetting the inflationary effect; and
 - inflation gives rise to fiscal drag by pushing taxpayers into higher tax brackets when their real incomes may not have increased.
- 1.36 The distortionary effects of inflation can be significant, but so too are the compliance and administrative costs of the conventional solutions. It may, nonetheless, be possible to devise approaches that tax only real returns from investment and savings and that are simple enough to markedly improve the tax system. We explore such an approach in Chapter Two, *Tax Bases*.

Limits to Making the Tax System Fairer and More Efficient

- 1.37 We have outlined above a number of principles that, if adhered to, will make the tax system fairer and restrict, where feasible, the economic costs of raising taxes. We note in this section the more significant of the constraints the government faces in designing tax rules.
- 1.38 First, we note that it is simply not feasible to tax some activities, the most obvious being those that do not produce monetary rewards (for example, leisure and unpaid work). Consequently, it is almost inevitable that the tax system will always impose a ‘wedge’ between paid and unpaid activities. The size of this wedge, and the magnitude of the resulting costs, reflects individuals’ marginal tax rates.
- 1.39 Secondly, we explained above that there is a close link between the economic costs of taxes and the range of opportunities available to taxpayers. The more options taxpayers have, the more responsive they will be to taxes, resulting in higher economic costs.
- 1.40 New Zealand’s increasing economic integration with the rest of the world is particularly relevant in this context. Economic integration brings important benefits and lifts incomes. The flow of ideas and people from overseas help New Zealanders become more skilled, educated and innovative, and help New Zealand businesses learn about and adopt leading-edge technology and management practices.

- 1.41 But greater openness also affects the nature and magnitude of the costs attributable to the tax system, in the process changing the nature of the constraints the government faces in designing tax policy. Skilled labour is increasingly mobile and international competition for such labour is increasing. The United States and the United Kingdom, for example, have recently relaxed their immigration rules for people with IT and other skills that are in short supply. In the future, some European countries may increase immigration to offset low birth rates and the fiscal strain of their ageing populations. In addition, Australia continues to be a strong magnet for skilled New Zealanders.
- 1.42 The growing international mobility of young, highly educated New Zealanders results in a loss to the Nation in addition to the cost of their education. Their departure represents a loss of potential innovators, technicians, managers and leaders, and an obvious social loss.
- 1.43 In addition, New Zealand is a significant importer of capital. We rely on the savings of foreigners to fund much of our investment. Without this capital, investment and wages in New Zealand would be lower. But the international mobility and competition for capital is also increasing. Many countries actively pursue foreign direct investment and most have policies to reduce the impact of taxes on the cost of imported capital.
- 1.44 Greater mobility of skilled labour and financial capital means the economic costs of taxes are higher than they were previously, for any given tax rate. Greater mobility also makes it increasingly likely that taxes on skilled labour and financial capital will be shifted onto others, including people without internationally marketable skills and landowners.
- 1.45 We address the implications for tax policy of New Zealand's need to retain and attract skilled labour and capital in Chapters Four, *Tax Rates*, and Six, *International Tax: Taxing Income from Inbound and Offshore Investment*.
- 1.46 The increased options available to highly skilled labour also have implications for the extent to which the tax system can be used to achieve redistributive objectives. Under the current tax scale and system of transfer payments, the lowest 50 percent of income earners are net beneficiaries (they receive more in transfers than they pay in taxes). All net tax revenue is contributed by the upper 50 percent of income earners.¹⁰ Some would question the long-term sustainability of this system.
- 1.47 We note, however, that changes in the limits on the government's ability to achieve equity objectives through the tax system do not mean these objectives need to be abandoned. Rather, it appears governments will need to rely more on alternative delivery mechanisms. We note in this context a recent OECD study that estimated that an increase in active spending from 0.63 to 0.73 percent of GDP on policies that improve education and labour-market opportunities in the lower part of the income distribution would increase long-run GDP per working-age population by one percent.¹¹

¹⁰ See Chapter Four, *Tax Rates*, for further details.

¹¹ Organisation for Economic Co-operation and Development, February 2001, *Growth, Inequality and Social Protection*, Paris.

Using the Tax System to Change Behaviour

- 1.48 The discussion thus far has emphasised the desirability of designing taxes so as *not* to unnecessarily change individuals' or firms' behaviour. In some instances, however, the government will wish to use the tax system as a means of deliberately adjusting behaviour. This section briefly examines circumstances under which governments might wish to use the tax system to:
- discourage 'bad' behaviour, including activities that have environmental consequences that impact on others; or
 - encourage 'good' behaviour, including activities that might be considered to have wider social benefits.
- 1.49 'Corrective' taxes are often advocated as a way of discouraging behaviour that imposes costs on people other than the taxpayer. We consider corrective taxes in some detail in both the sections dealing with excise taxes and duties in Chapter Two, *Tax Bases*, and Chapter Three, *Environmental Externalities and Eco-Taxes*.
- 1.50 Some submissions pointed to a need for New Zealand's tax system to be internationally competitive. In part, our views on international competitiveness are set out in the discussion above, on the implications for tax design of increasing international economic integration. We also discuss aspects of international competitiveness in Chapter Six, *International Tax: Taxing Income from Inbound and Offshore Investment* and in Chapter Four, *Tax Rates*.
- 1.51 Tax incentives for particular activities or industries are sometimes advocated as ways of enhancing their competitiveness. In our view, concessions cannot be justified unless there would be insufficient investment in their absence.
- 1.52 In principle, tax incentives involve applying lower effective tax rates to selected activities or investments and higher rates to other activities or investments. Incentives will sometimes lead to increased overall investment, but will more often result in a reallocation of existing investment away from unsubsidised investments and towards subsidised activities.
- 1.53 Incentives work by deliberately distorting market signals about the relative attractiveness of alternative investments. This makes sense only if market signals are for some reason misleading. Market signals will most likely be misleading where an economic activity generates returns to society that significantly exceed the before-tax returns received by the taxpayer.
- 1.54 An excess of social returns relative to private returns is sometimes referred to as a 'spillover', since some of the benefits from the investment spill over from the taxpayer to other parties. Where spillovers occur, investment in the affected activity will likely be lower than is socially desirable. This situation could be remedied by subsidising the activity, perhaps by way of tax incentives. But subsidies cannot be provided costlessly.

Consequently, subsidising spillover-generating activities by way of tax incentives only makes New Zealand better off, if the prospective benefits associated with an incentive outweigh the potential costs. Even then, incentives should only be introduced if they are found to be superior to any alternative policy response.

- 1.55 However, the prospective benefits from an incentive are usually unclear. The empirical evidence on the existence and size of spillover effects is contradictory and inconclusive. Various studies have purported to find significant spillovers to research and development, investment in human capital, investment in equipment, and investment in infrastructure. Other studies, using different methodologies and/or data, purport to refute these results. Unfortunately, data and methodological limitations are such that we are seldom likely to see sufficiently compelling evidence to warrant the conclusion that the benefits from a particular incentive are likely to be large relative to its costs.
- 1.56 While the benefits of incentives are uncertain, the costs are usually relatively clear. Incentives result in non-uniform effective tax rates being applied to different investments. And, as noted above, non-uniform tax rates impose a variety of costs. These include increased administrative and compliance costs, and higher taxes (and hence excess burdens) on other activities. Selective incentives result in opportunities for taxpayers to avoid tax by recharacterising otherwise non-qualifying income or expenditure so that it qualifies for the incentive. Selective incentives also motivate taxpayers to devote considerable resources to lobbying for further incentives. Avoidance and lobbying both divert valuable resources away from productive activities.
- 1.57 As a general principle, we believe there should always be a strong presumption against extending concessionary treatment to any particular activity or sector, whether the concession is advocated on grounds of international competitiveness or for other reasons. This does not mean that a case for such concessionary treatment cannot be made, just that it needs to be made and scrutinised rigorously and that there is strong burden of proof to be demonstrated before the concessionary treatment should be allowed.

Tax Avoidance

- 1.58 As explained above, most of the economic costs of revenue taxes result from their adverse impact on the behaviour of people and institutions. A tax on wages will cause some people to stop working, just as a tax on commodities will stop some people buying them. Most of the behavioural impacts of a tax are unavoidable and it would clearly be foolhardy to attempt to legislate against them. The law could hardly oblige people to buy commodities or retain employment where a tax causes them to do otherwise.

- 1.59 At the same time, not all tax-induced behaviours are acceptable. For example, evasion, being the illegal avoidance of tax, is unacceptable. The harder question is whether there is a category of avoidance behaviour, not comprising evasion, that can be identified and usefully prohibited by law. We believe there is.
- 1.60 From a design viewpoint, the first question to consider is why tax avoidance law might improve the national interest. The next questions are whether existing avoidance law can be improved, and if so, how might it be improved.
- 1.61 The economic benefit of an effective tax avoidance law is a reduction in distortionary behaviour and therefore in the excess burden of taxation. The economic costs of such a law are first, the risk that it misfires and suppresses beneficial economic behaviour and secondly, the transaction costs of administration and compliance. The former cost derives from two aspects of the subject, namely uncertainty and the blockage of tax-driven behaviour that the tax system is willing to accommodate (such as with respect to corrective taxes and targeted elective regimes).
- 1.62 There appears to be a lack of consensus in New Zealand about the effectiveness of existing avoidance rules and approaches. For example, the Valabh Committee was keen to revise the income tax avoidance rules, whereas the Committee of Experts preferred to leave them largely unaltered. Some commentators prefer that there be no general income tax avoidance law, whereas others argue that such law should be judicial rather than legislative. And finally, there is a diversity of judicial approach across time and place to defining and applying avoidance provisions. This has particularly been the case recently in the United Kingdom where the pendulum has swung between various formal and substantive approaches. Unfortunately, this diversity of opinion contributes to an uncertain and unstable tax avoidance law.
- 1.63 Arguably the test for adequacy of the existing rules turns on their ability to enable people to predict that an anticipated arrangement, or determine that an actual arrangement, constitutes tax avoidance. A contrary argument is that an uncertain tax avoidance law results in less avoidance since it increases the cost of tax avoidance transactions. Unfortunately, however, uncertainty will also kill off some legitimate transactions and complicate the resolution of disputes.
- 1.64 We have raised the question of tax avoidance because we are interested in receiving submissions on these issues, and in particular on how the existing law could be improved. We note, however, that broad-based taxes that are expressed simply and clearly in legislation and that enable rates to be as low and as uniform as possible reduce both the opportunity and incentives for avoidance. A broad tax base and a uniform rate approach to tax design means that:
- the tax system applies the same tax rate to different taxpayers and different transactions. This reduces the disparities that influence decisions by taxpayers;
 - there are few ways in which income can be transferred in non-taxed form between taxpayers; and
 - tax revenue can be raised with lower average tax rates. This reduces the effect of remaining disparities on taxpayer behaviour (for example, between taxed employment and untaxed work around the home).

The Tax Policy Process

1.65 To date, we have discussed the various features of good tax policy. We now turn to policy institutions and ask: “Can the tax policy process deliver better policy outcomes?”

1.66 Taxation is an intrusive exercise of the state’s coercive power. Public expenditure involves distributing money, goods and services; tax involves distributing the costs of that expenditure. The high demand for public expenditure is matched by an equal lack of enthusiasm by individual taxpayers to meet that cost. It is the worldwide experience of governments, historically and currently, that taxation is unpopular. It is unreasonable to expect any tax policy process to change this. On the other hand, the better the process the more likely tax legislation will accurately reflect policy objectives.

The generic tax policy process

1.67 Since 1995 the tax policy in New Zealand has been developed in accordance with the Generic Tax Policy Process (GTPP), which was recommended by the Richardson Review of IRD.

1.68 The main objectives of the GTPP were to:

- encourage earlier, explicit consideration of key policy elements and trade-offs;
- provide opportunities for substantial external input into the policy formulation process, to increase transparency and to provide for greater contestability and quality of advice at all stages;
- clarify the responsibilities and accountabilities of participants in the process;
- manage better the tax policy process; and
- ensure that the performance of tax policy initiatives, as well as the process of reform, is reviewed regularly.

1.69 The GTPP has five key development stages:

- **strategic:** develop an economic strategy, a fiscal strategy and a three-year revenue strategy;
- **tactical:** develop a three-year work programme and an annual resource plan;
- **operational:** design detailed policy, formally consult, and gain Ministerial and Cabinet approval of detailed policy recommendations;
- **legislative:** translate the detailed policy recommendations into legislation (this stage can occur concurrently with the operational stage); and
- **implementation and review:** implement legislation, review legislation post-implementation and identify remedial issues.

- 1.70 The GTPP improved how tax policy is developed. Major tax initiatives are now subjected to much greater public scrutiny at key stages in their development. The process enables policy advisers to develop more practical options for change, through consultation with professional associations, tax practitioners and those who will be affected by the proposed reforms.
- 1.71 That said, we do not think that the GTTP has ever delivered as much as it could. In practice, the operational and legislative phases have dominated.
- 1.72 We see three areas where improvements to the operation and application of the GTTP are warranted. These proposals would, if implemented, bring the practice of the GTTP closer to the system as the Richardson Review recommended it. The areas are:
- introduce greater transparency of measuring the success of tax policy;
 - establish forums for independent policy analysis; and
 - increase participation of stakeholders.

Transparency of policy success

- 1.73 Requiring Ministers to account publicly for their policy outcomes is often a very powerful spur to action. This is the basis of the Fiscal Responsibility Act. The government could be required to publish:
- measures of tax policy success;
 - its plans to achieve success; and
 - progress on its achievement.
- 1.74 One particular possibility here would be the requirement to publish a ‘tax expenditures statement’ that sets out the fiscal costs of departures from some policy benchmark. Today over half of the countries in the OECD prepare tax expenditure statements. The last time New Zealand published such a statement was as part of the ‘opening of the books’ in 1984.
- 1.75 While there are difficulties with the preparation of a tax expenditure statement, none of these issues is insurmountable. The IMF’s *Manual on Fiscal Transparency* states:

Although there can be serious difficulties in cost estimation, reporting the approximate cost and making the basis of the estimates available for independent scrutiny can significantly enhance the transparency of fiscal management.

Independent policy analysis

- 1.76 While New Zealand has a very open tax policy process when compared to many other countries, much of that openness is actually limited to a narrow range of players: taxpayers and their advisers. There is very little involvement of less self-interested players, most notably the academic community.
- 1.77 Here it is important to note that while public service advisers do give free and frank advice to ministers, constitutional conventions and public service ethics limit their role as public advocates of policy. That is, their role is to “advise fearlessly and implement enthusiastically”. Once the government has made its policy decisions, public servants are seriously (and within our system of government, we would argue, appropriately) constrained on their ability to comment on the merits of that policy. Their role is to explain the reasons behind the government’s chosen policy, not to advocate it or criticise it.
- 1.78 Some possible sources of more independent analysis are:
- universities;
 - independent policy institutes; and
 - Parliamentary Committees.
- 1.79 Internationally, we see the UK Institute of Fiscal Studies as providing a potential model for New Zealand.

Increased stakeholder participation

- 1.80 It is not just affected taxpayers who have a stake in the tax system. The recipients of government expenditure want to know that the costs to society of the taxes that finance that expenditure are low and that revenue sources are secure. We think that many of the initiatives outlined above will make it easier for all stakeholders to participate in the tax policy process.
- 1.81 Opposition parties are also key stakeholders in the tax policy process, but are not explicitly well catered for at present. But opposition parties in New Zealand are becoming more explicit in their tax policy proposals and are giving increasing commitment to implementing those policies.
- 1.82 Independent analysis of all political parties’ tax policies prior to each election would be a valuable outcome.

Specialist tax court

- 1.83 We received a submission that a specialist tax court within the High Court jurisdiction be established as an originating jurisdiction for tax disputes. The submission was based on two principal arguments. First, the current system allows taxpayers a choice between initiating proceedings in the High Court or the Tax Review Authority. This results in a

tactical opportunity for taxpayers, which is unlikely to coincide with the national interest. Secondly, taxation law is extremely complex and judges should preferably have an extended exposure to tax law and practice. We have not developed conclusions on these issues and would welcome submissions on them. As a preliminary observation, however, we are not inclined to support the idea that tax judges have no exposure to non-tax litigation. If a specialist court did exist, we are inclined to the view that judges should be rotated through that court, albeit for an extended period.

- 1.84 We also received a submission questioning the propriety of tax litigation being resourced by in-house legal counsel. The question was whether a greater degree of independence over managing tax litigation on behalf of the Crown was desirable. We would also welcome submissions on this point.

CHAPTER TWO

TAX BASES

Income Tax

The New Zealand income tax base is one of the cleanest in the OECD. There are few major gaps in the tax base, which means that the income tax is generally both fair and efficient.

The two most important gaps addressed in this chapter are capital gains and the taxation of housing.

We do not favour a traditional capital gains tax; the cost of imposing it is likely to exceed the benefits. But the status quo can be improved. We propose considering two possible options for reform.

One option is to continue New Zealand's previous policy of responding to individual spot issues as they arise. This approach is likely to see the tax base expanded progressively to bring more income into the tax base.

The other option involves more fundamental reform. A 'risk-free return' approach would apply to some forms of income from capital. A taxpayer's annual taxable income in respect of net assets taxed under this approach is the value of the assets times an inflation-adjusted risk-free rate of return. If applied today, the rate would be about four percent.

If this approach was adopted, we think it would be most clearly apply to shares and residential rental property.

New Zealanders put more of their savings into owner-occupied housing than people in most other countries. Tax advantages are part of the explanation. Owning is more tax effective than renting and gains on sale are tax free.

We think that the risk-free return approach is the most viable of the alternatives for bringing housing into the tax base. Any increased revenue from this approach should be applied to reducing income tax rates.

We do not see any case for introducing new taxes on wealth.

While attractive in theory, a cash-flow tax is likely to prove impractical. We do not propose to investigate such a tax further.

GST is an ideal tax based on our framework. It is less regressive than many think. Concerns about regressivity are better dealt with through government expenditures or the income tax system than through changes to GST.

We do not believe a financial transaction tax is a viable alternative to GST. Nor is a Tobin tax on currency transactions likely to be welfare enhancing.

The government should consider repealing a range of existing minor taxes, such as gift duty and cheque duty.

Excises and Duties

Selective taxes on alcoholic beverages, tobacco, gaming and petrol raise about \$2.8 billion in revenue.

Many of these taxes appear likely to have high deadweight costs per dollar of additional revenue raised relative to broadly based forms of taxation. While our estimates are no more than illustrative, they suggest that it is difficult to justify current levels of excises and duties on efficient taxation grounds.

Our review of the evidence also suggests that many New Zealanders of modest means will pay as much or more indirect tax via alcohol and tobacco excise and gaming duties than they pay in GST levied on all of their spending.

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

Excises and duties are nowadays recommended as a means of promoting healthier lifestyles, as charges for the use of the health system or as a means of correcting a variety of other 'market failures'.

The Review is not attracted to 'social spending' arguments as a basis for corrective tax policy. In our view a more sensible and consistent approach would accept moral hazard as part of the price of the public health system.

- 2.1 New Zealand's current tax system collects revenue in three main ways: through an income tax and a broad-based tax on expenditure and excises. Our terms of reference require us to consider whether New Zealand should retain these and the other existing taxes, whether their bases should be extended or reduced, and whether new taxes should be introduced to complement or replace the existing ones.
- 2.2 We received many submissions on these issues. A large number of submissions were generally supportive of the current income tax and GST, and particularly of the 'broad-base, low-rate' approach to these taxes. We note that the OECD's November 2000 Economic Survey of New Zealand also expressed a generally positive view of New Zealand's tax system, stating that it "*compares favourably with those of other OECD countries and is not in urgent need of major reform.*"¹²
- 2.3 Submissions expressed a wide range of views on excises, and we have devoted significant attention to the question of the appropriateness of excises and other taxes

¹² OECD, 2000, *OECD Economic Surveys November 2000: New Zealand*, p 133. See also the cross-country comparisons of effective tax rates on investment in Chapter Four, *Tax Rates*.

levied on specific types of expenditure, production or transaction in the context of the broad-base, low-rate principle.

- 2.4 In the first section of this chapter we discuss income tax and the merits of extending or otherwise amending the income tax base. We focus particularly on the taxation of capital gains and returns to owner-occupied housing. While we do not favour the conventional approaches to these topics, we develop an alternative approach that we believe potentially has merit. We also examine the possibility of replacing income tax with a cash-flow tax. In the second section, we consider GST and the various transaction duties. We consider the possibility of replacing these taxes with a general tax on financial transactions, and we look at a tax on foreign exchange transactions – the Tobin tax. In the final section we draw together our views on the viability of the various tax types we have examined, and consider the best mix of taxes in the light of the current tax mix in New Zealand and in other OECD countries.

Taxes on Income and Wealth

Income tax

- 2.5 It is useful for the discussion that follows to define and briefly discuss the core concept of ‘comprehensive income’. In the context of individuals, comprehensive income for a period (say, a year) is the sum of the change in the individual’s net wealth between the beginning and end of the year and the amount they spent on consumption. Put another way, it is the total amount an individual could spend on consumption over the year without being any worse off than they were at the start of the year.
- 2.6 In the context of entities, such as companies, the corresponding concept is the sum of the change in the value of the entity’s net assets between the beginning and end of the period and its net cash flows. Equivalently, it is the amount that if distributed to the entity’s owners would result in the entity being worth the same amount at the end of the year that it was worth at the beginning of the year.
- 2.7 Comprehensive income can be measured in either nominal or real terms. Under a nominal base, changes in the value of net assets or wealth are measured without making any adjustment for inflation. Under a real base, purely inflationary changes in the value of wealth or assets are excluded.
- 2.8 Where the income tax base coincides fully with either of these concepts of comprehensive income, it will be consistent with both the notion of horizontal equity and the concept of economic efficiency. Individuals with the same income but of varying composition will face the same tax liabilities, and different investments that yield the same before-tax returns will be subject to uniform effective tax rates, so the tax system will not distort investment decisions.

- 2.9 We emphasise at this point that the notion of comprehensive income is a theoretical concept that can never be fully achieved under any real-world income tax. Among other things, implementation of a comprehensive income tax would require measuring on an accrual basis the annual change in value of every asset and liability of every taxpayer. Instead, the concept is best regarded as a benchmark against which the properties of our income tax, and of potential changes to it, can be assessed.
- 2.10 The income tax is New Zealand's most important tax base in terms of revenue raised. The income tax accounts for almost two thirds (62 to 64 percent) of the government's total tax revenue, or about \$21.5 billion (20.5 percent of GDP) in 1999/00. Almost 68 percent of this sum was collected by way of PAYE or withholding taxes, with 90 percent of this being PAYE on wages and salaries.¹³ The balance comprises fringe benefits tax, company tax and other taxes on business and investment income.
- 2.11 Whereas PAYE tends to be a relatively stable source of government revenue measured as a percentage of GDP, company and other business taxes are more variable. For example, in 1999/00 net company income tax comprised just under 20 percent of total income tax revenue compared to 14.4 percent in 1992/93.
- 2.12 While it is a relatively small part of the income tax base, company tax plays two critical roles in the workings of the general income tax system. First, it ensures that tax is collected on income of a company that is attributable to resident shareholders and is reinvested in the company. Since imputation credits will be available when taxed retained earnings are ultimately distributed, company tax operates for resident shareholders in a similar way as PAYE operates for wage and salary earners. Secondly, it taxes the income of a company (including income distributed as dividends) that is attributable to non-resident shareholders. For non-resident shareholders, the company tax is effectively a final tax.
- 2.13 As we stated in our letter seeking submissions, our current income tax has a relatively broad and comprehensive tax base compared with income taxes in other similar economies. Wage and salary earners are taxed on most of the labour income they receive, fringe benefits are taxed and, unlike most other OECD countries, there is no threshold of earnings below which tax is not payable or exemption for pension contributions. While there are greater opportunities to earn untaxed income under the rules applying to income from capital, the base is still relatively comprehensive by international standards, with few tax concessions.
- 2.14 Again, the comprehensiveness and neutrality of our income tax system was highlighted in the OECD's 2000 Economic Survey of New Zealand. The OECD noted that: "*In comparison with other OECD countries, [in New Zealand] marginal effective tax wedges across various investment and financing vehicles are almost uniform, pointing to low overall tax-induced distortions to corporate financing decisions.*"¹⁴ In other

13 The other withholding taxes are those on interest, dividends and payments to non-residents.

14 OECD, 2000, *OECD Economic Surveys November 2000: New Zealand*, p 106.

words, compared to other countries, investments in New Zealand are more likely to be determined by their expected economic prospects than by the prospect of a subsidy from other taxpayers. Consequently, business decisions are more likely to be made for commercial and not tax reasons.

2.15 However, despite a significant broadening of New Zealand's income tax base since 1982, gaps remain. Some reflect deliberate policy decisions, like accelerated depreciation rates. Some are the consequences of other policy decisions. An example here is the complex share buy-back rules, which are the consequence of the decision not to tax capital gains. As noted above, measurement difficulties are a practical reason for some gaps in the base.

2.16 A number of gaps and anomalies in the corporate tax base are hard to justify on any grounds, although we suspect that a number are historical hang-overs from previous policies that have endured into the modern age. While many of these provisions are beneficial to taxpayers, they come at a cost:

- compliance costs are higher;
- administration is more costly; and
- they can distort taxpayers' business decisions, leading to higher than necessary dead-weight costs.

2.17 Some of these gaps are significant: accelerated depreciation and immediate deductibility of expenses in areas like forestry, films, mineral mining and petroleum mining.

2.18 We therefore consider that there may be advantages in taxing business on a more consistent basis. This would involve considering the case for repealing the sector-specific regimes noted above, with a strong presumption that 'normal' rules should apply where practicable.

Major gaps

2.19 The rest of this section focuses on the most significant gaps in the income tax base as identified in submissions – capital gains and housing – and on research and development.

Capital gains

2.20 We noted above that a comprehensive definition of income would include all changes in the annual value of assets and liabilities, irrespective of whether the changes legally constituted 'ordinary income' or 'capital gains'.

2.21 Unlike most other OECD countries, New Zealand does not have a separate capital gains tax. The ordinary income tax base does, however, capture a wide range of changes in the value of assets and liabilities, including all gains by holders of debt instruments, gains on the sale of land by developers, gains realised in the ordinary course of business

and anticipated losses in the value of capital assets (by way of depreciation deductions). The main exclusions (by value) are certain shares and real property.

- 2.22 We note that the extreme approach of exempting from tax all changes in the value of assets and liabilities would have the effect of converting the income tax into a cash-flow tax. For reasons discussed below, we do not believe this is a viable option.
- 2.23 So the issue is not whether we should tax capital gains at all. Rather, it is whether we should tax capital gains more comprehensively than we do at present, whether by including more capital gains in taxable income or by introducing a separate tax on capital gains. Of other OECD countries, Japan, Luxembourg, Norway, Poland and Turkey appear to generally tax capital gains in normal income. Austria, Greece, Korea, Mexico, The Netherlands, and Switzerland neither have a general tax on capital gains nor widely tax capital gains as ordinary income.¹⁵ The remaining OECD countries have separate capital gains taxes.
- 2.24 In considering the extent to which capital gains should be taxed, we have first considered the type of comprehensive realised capital gains tax advanced in the 1990 discussion document *The Taxation of Income from Capital*.
- 2.25 The 1990 discussion document proposed the inclusion of all income from capital, including capital gains, in taxable income. Capital gains were to be taxable only when the gain was realised, generally by way of the sale of the asset on which the gain was made. The OECD in its 2000 Survey proposed a realised capital gains tax for New Zealand, asserting that it would “*eliminate or substantially reduce many of the weaknesses of the tax system.*”¹⁶ The 1990 discussion document also proposed that all capital income, including capital gains, should be indexed to exclude from the tax base any amount that merely compensated for the effects of inflation. The OECD considered that indexation is unnecessary so long as the current low inflation environment is sustained.¹⁷ We return to this issue below.
- 2.26 The arguments for taxing capital gains along the lines outlined in the 1990 discussion document can be summarised as:
- making the tax system fairer, since those deriving income from capital gains would pay the same tax as those making income in a form that is taxable under current law;
 - making the tax system more efficient, by ensuring that investments yielding capital gains are not taxed more lightly than other investments;
 - raising more revenue from the income tax base, allowing income tax rates to be lowered or other taxes to be reduced; and

¹⁵ Hong Kong, Singapore, and Taiwan also do not generally tax capital gains.

¹⁶ OECD, 2000, *OECD Economic Surveys November 2000: New Zealand*, p 127.

¹⁷ *Op cit*, p 127.

- preventing taxpayers using the absence of capital gains taxation to convert otherwise taxable income into non-taxable capital gains.

2.27 The argument that a capital gains tax has no theoretical merit was put forcefully to us in submissions. One submission argued that a capital gains tax should be rejected on the basis that it would amount to double taxation of income. We have considered that argument but do not accept it. We prefer the analysis in the 1990 discussion document.¹⁸

2.28 While the argument for taxing more capital gains is strong on a theoretical level, capital gains taxes as they apply overseas, and as proposed for New Zealand in 1990, fall short of the theoretical ideal of taxing capital gains as they accrue. Instead, other countries generally tax capital gains only when gains are realised. This sort of tax is not ideal. The tax becomes a transactional tax on the disposal of assets, analogous to a stamp duty. This makes the tax system complex and costly. It also significantly decreases the effectiveness of the tax.

2.29 It is necessary when taxing capital gains to also allow deductions for capital losses to avoid seriously biasing investment away from riskier assets. However, allowing deductions for capital losses provides strong incentives for people to defer realising gains on assets that have increased in value¹⁹ but to accelerate realisations of assets that have fallen in value.²⁰ This behavioural response, which cannot be prevented under a realisation-based tax, reduces the revenue from the tax and ties assets up unproductively.²¹ It also means effective tax rates can be just as disparate when capital gains are taxed as when they are not.

2.30 Other problems with realisation-based taxes on capital gains include:

- determining which of the myriad of ways of transferring full or partial economic ownership of an asset are to be treated as ‘realisation events’ for capital gains tax purposes. For example, at which point along the continuum of leasing an asset for a day and leasing it for the remainder of its economic life should an asset be deemed to have been sold? Inevitably, difficult (and arbitrary) boundaries need to be defined;
- determining whether a tax liability should be triggered when an asset is disposed of but replaced by a like asset (as, for example, with a share swap). Most overseas

¹⁸ *The Taxation of Income from Capital*, discussion document, 1990, pp 201-208.

¹⁹ The incentive to defer disposing of an asset where gains are taxable on realisation is commonly referred to as a ‘lock in’ effect.

²⁰ As we note below, real-world capital gains taxes make unavoidably arbitrary distinctions between what does and what does not constitute a ‘realisation’ and what does and what does not qualify for ‘rollover relief’. These distinctions inevitably create opportunities to ‘realise’ losses while retaining economic ownership of an asset or to relinquish economic ownership without triggering a ‘realisation event’. Attempts to combat such behaviour by, for example, restricting the use of ‘capital’ losses are never fully successful. They bias the tax system against investment in riskier assets and add to its complexity.

²¹ We also believe that, in present value terms, a realisation-based capital gains tax would collect significantly less revenue than might appear to be the case at first sight. Most capital gains and losses are attributable to riskier assets. The revenue from taxing those gains should therefore be discounted at a higher discount rate that allows for the higher risk, reducing the present value of the tax.

jurisdictions with capital gains taxes provide ‘rollover relief’, allowing the tax-free realisation of assets so long as the proceeds are invested in similar assets. Providing rollover relief is sometimes economically desirable – in the share swap example, rollover removes a tax bias against mergers. Other times, it is economically undesirable – for example, where it ‘locks’ a taxpayer into continuing to invest in a particular type of asset where other investments would be more desirable in the absence of tax considerations; and

- determining both what constitutes an asset – intangible property is particularly problematic – and its costs.

2.31 The capital gains tax regimes in the jurisdictions that have them tend to be some of the most complex areas of tax law. Unlike most other complex areas of the tax law, the capital gains rules have to be interpreted and applied by taxpayers of relatively modest means. Some of the consequences appear to be:

- the taxes are often perceived as being unfair or unreasonable;
- as legislatures seek to dispel these concerns, capital gains taxes tend to be subjected to more legislative change than other areas of the tax law, making the law more uncertain and, often, resulting in increasing arbitrariness in the application of the law; and
- as both exemptions and complexity increase over time, other jurisdictions’ capital gains taxes can end up imposing compliance costs that appear quite disproportionate to the amount of revenue raised.

2.32 Finally, we do not consider that the inflation issue can be dismissed as easily as the OECD did. The example in Chapter One, *Frameworks*, illustrates that even low rates of inflation can significantly distort effective tax rates.

2.33 These concerns are in our view sufficiently serious for us not to propose at this stage to include within our final report a suggestion for taxing capital gains more widely on a realisation basis.

2.34 Having decided against recommending a more widespread tax on capital gains, the question remains: how best to deal with problems arising from the current system. We intend further exploring two broad approaches. The first involves a continuation of the pragmatic approach New Zealand has adopted in the past. The second involves a fundamental change to the way we tax income from capital, at least in certain instances.

The pragmatic approach: respond to problems as they arise

2.35 The government’s past approach has been to extend the tax base to include capital gains as necessary to deal with specific problems that have emerged. For example, certain payments that could be substituted for salary and wages and other taxable income from employment have been made taxable in order to protect the income tax base. Redundancy payments were made taxable in 1992, and the government has moved this

year to make payments in respect of restrictive covenants and exit inducement payments taxable.²²

2.36 Another example of the pragmatic approach has been the treatment of capital gains in relation to certain land transactions. For policy reasons, gains generated by individuals who acquired the land for the purpose of resale, such as land dealers, land speculators or builders, were deemed to be taxable. Without such an approach the ‘profits’ made in such businesses could be structured to be largely non-taxable.

2.37 Under this option, New Zealand would continue with this pragmatic approach. We have identified a number of areas where the inconsistencies in the tax treatment of capital gains may be creating problems. These are:

- the inconsistent treatment of different savings vehicles. Our thinking on this is covered in Chapter Seven, *Savings*;
- the impact on the treatment of offshore investment. Our thinking on this is covered in Chapter Six, *International Tax: Taxing Income from Inbound and Offshore Investment*;
- the possible effects on investment in housing. Our thinking on this is covered in the next section; and
- the opportunities that the absence of a capital gains tax may give for taxpayers to transform otherwise taxable income into capital gains. These opportunities are best dealt with as specific opportunities are identified.

Fundamental reform: the risk-free return method

2.38 We have explored the merits of taking a more fundamental approach to reforming the taxation of income from capital, at least in respect of some investments. For ease of reference, we have termed this the risk-free return method (RFRM). Annex A compares the RFRM to the conventional approach to taxing income from capital, and provides more detail on the key issues that would have to be addressed were this approach to be developed further.

2.39 The tax base under the RFRM is the amount that would have been earned if:

- the funds invested in an asset subject to the regime had instead been invested in a risk-free government bond; and
- the portion of the return on the bond that represented compensation for inflation was exempt from tax.

2.40 Application of the RFRM would in most instances be extremely straightforward. Tax payable in respect of assets that were subject to the RFRM would be calculated simply as:

²² This move was foreshadowed in *Tax Compliance: A Report to the Treasurer and Minister of Revenue by a Committee of Experts on Tax Compliance*, 1998, chapter 3, and Inland Revenue issues paper, June 2000, *Services-related Payments: Restrictive Covenants and Exit Inducements*.

$$\begin{array}{c}
 \text{Value of net assets at beginning of the tax year} \\
 \times \\
 \text{Inflation-adjusted risk-free rate of return} \\
 \times \\
 \text{Investor's tax rate}
 \end{array}$$

- 2.41 Net assets would be calculated as the aggregate opening market value of assets owned by the taxpayer that were subject to the RFRM, reduced by the outstanding principal on related debt – interest expense would not be tax-deductible.
- 2.42 The ‘inflation-adjusted risk-free rate of return’ would be calculated by reference to government stock rates, reduced in respect of expected inflation. We envisage that this rate would be around four percent.
- 2.43 The RFRM overcomes the various problems listed above that are due to the less than comprehensive taxation of capital gains, while avoiding the problems associated with the taxation of capital gains on realisation. For example:
- the RFRM will not sway taxpayers’ decisions about whether to invest in ‘income’ or ‘growth’ shares since tax liabilities are independent of the extent to which returns to an asset comprise cash or capital growth;
 - the RFRM is fair, in the sense that any two taxpayers with the same start-of-year wealth will face the same tax liability, irrespective of any differences in the types of asset they invest in;
 - the RFRM provides a straightforward way of effectively indexing the tax system for inflation, simply by using an inflation-adjusted, rather than nominal, risk-free rate of return in the calculation; and
 - there is no advantage under the RFRM to be had from recharacterising ‘taxable income’ as ‘capital gains’.
- 2.44 A number of issues would have to be addressed before a decision could be taken to introduce an RFRM. Some of these include the following:²³
- **scope of the regime:** the RFRM could in principle be applied in any instance where an objective estimate of an asset’s start-of-year value was available. Obvious examples include listed shares, in both New Zealand and foreign companies, and commercial real estate. It would be desirable if the approach could also be applied to other financial instruments held by individuals, such as debt instruments;
 - **integration between RFRM and company tax:** applying the RFRM to listed shares would make redundant many of the tax rules governing the interface between listed companies and shareholders, since all payments from companies to shareholders would be tax exempt, whether they comprised dividends or the return of capital. It would, however, be necessary to devise an alternative approach to the current imputation regime to ensure that company income was not taxed twice; once at the

²³ See Annex A for a fuller discussion.

company level and again under the RFRM. Annex C briefly outlines two alternative approaches that could be explored further;

- **liquidity issues:** since the RFRM is calculated independently of cash flows, situations would sometimes arise where annual tax payable exceeded the cash generated by the assets to which the tax applied. The question then arises as to whether (and, if so, when) special rules should be devised to extend some form of relief to cash-strapped taxpayers. Again, Annex A further considers this issue; and
- **within-year portfolio changes:** the simple calculation set out above – opening assets x inflation-adjusted risk-free rate – will not necessarily be appropriate where, within a year, a taxpayer acquires additional assets or disposes of assets subject to the RFRM, or takes on or repays debt.²⁴

2.45 While it will appear novel to New Zealanders, this general approach is applied elsewhere. For example, The Netherlands has an ‘investment yield tax’, under which a flat tax rate of 30 percent is applied to an imputed return on a taxpayer’s net investments, including any housing (other than the taxpayer’s principal residence). The taxpayer’s net assets – assets less debt relating to the assets – are deemed to make a presumptive return of four percent per annum. This return, not the actual return, is then taxed. No deductions can be offset against this income, though taxpayers do enjoy a tax-free allowance.

Owner-occupied housing

2.46 Several submissions raised concerns with the tax treatment of owner-occupied housing, mainly because of its impact on New Zealanders’ savings patterns. The OECD was seen as offering a possible response in its 2000 Economic Survey of New Zealand.

2.47 Under the OECD’s proposals, all income from owner-occupied housing would be brought into the base since the OECD proposes both the general taxation of capital gains and of imputed rental income.²⁵ Homeowners would be able to deduct mortgage interest, depreciation and expenses relating to repairs and maintenance, largely replicating the tax treatment applying to landlords.

2.48 Income from owner-occupied housing takes two forms: changes in the value of the property (or capital gains) and the consumption benefit.²⁶ The annual value of the consumption benefit of owner-occupied housing is in principle, at least, equal to the rent that would have been paid if the household had instead rented accommodation of the same standard. This amount is referred to as ‘imputed’ rental income. Neither of these components of income attributable to owner-occupied housing – capital gains or

24 The Netherlands, which has a similar tax, deals with these issues by basing the tax calculation on an average of opening and closing net assets. This approach has the advantage of simplicity, but would need to be tested to determine whether it was appropriate in our circumstances.

25 OECD, 2000, *OECD Economic Surveys November 2000: New Zealand*, pp 127-128.

26 Recall that ‘comprehensive income’ was defined at the beginning of this section as the sum of consumption and changes in an individual’s wealth over the tax period.

imputed rental income – is currently subject to tax. Owner-occupied housing is only tax preferred to the extent that it is not debt financed. Payment of (non-tax deductible) interest transfers part of the normally non-taxable investment return from housing to the lender who is subject to tax on the interest. This restricts the advantage to a homeowner's net housing equity.²⁷

2.49 The economic consequences of not taxing income from owner-occupied housing can be summarised as follows:

- it is likely to result in less investment in assets that generate taxable returns, and more in housing, than would occur if there were no difference in tax treatment. The OECD estimates that housing makes up over 70 percent of total household assets in New Zealand, in comparison to most other OECD countries where housing constitutes less than half of household wealth;²⁸
- it is not horizontally equitable. Two households with the same level of wealth and employment income will be subject to very different levels of tax if one has its investment in housing and the other lives in rental accommodation and has bank savings;
- it is regressive. Lower income households rely more heavily on rental accommodation. In the 1997/98 Household Economic Survey, 38 percent of households in the lowest 30 percent of household income groups paid rent. On the other hand, only 21 percent of the top 30 percent of households by income, 17 percent of the top 20 percent of households and 11 percent of the top 10 percent of households paid rent;²⁹
- the regressivity is further exacerbated by the effective restriction of the benefit to individuals' net housing equity. Even where lower income households own rather than rent, they are more likely to have a mortgage; and
- since older households are more likely to have paid off their mortgage, they generally enjoy a larger tax benefit than younger households with similar incomes. The 1997/98 Household Economic Survey shows that 50 percent of households earning the lowest 30 percent of market (that is non-benefit) income paid no interest or rent on their home. This compares with 42 percent of all households that are in this group and 46 percent of the top 10 percent of income-earning households.³⁰

2.50 The significance of home ownership in New Zealand is such that these factors are likely to be of material consequence. Housing is by far the main form of investment

27 The non-deductibility of interest leads to other economic inefficiencies and inequities. It means the tax system encourages households in owner-occupied housing to repay their mortgage as quickly as possible, contributing to the low level of non-housing investment held by New Zealand households. And because taxpayers who have assets that generate taxable income can, if properly advised, arrange their affairs to ensure their debt is attributed for tax purposes to the income producing assets rather than their housing, the current rules can result in seemingly arbitrary differences in the way well advised and poorly advised taxpayers are taxed.

28 OECD, 2000, *OECD Economic Surveys November 2000: New Zealand*, p 125.

29 1997/98 HES, The Treasury, July 2000, table 7.

30 *Op cit.*

undertaken by New Zealand households.³¹ Over 70 percent of New Zealand households own their own home and about 46 percent of private dwellings is mortgage free.³²

- 2.51 The theoretical case for taxing returns to owner-occupied housing is strong; the current system is both inefficient, since it induces over investment in housing at the expense of accumulation of financial assets, and inequitable, since it favours high income earners and the elderly at the expense of struggling lower income families. While the system could be made more equitable by allowing deductibility of mortgage interest, this would worsen incentives to over invest in housing.
- 2.52 However, we would not recommend taxing returns to owner-occupied housing unless a viable regime could be developed that did not involve unreasonable compliance costs and that could be shown to improve the fairness and efficiency of the tax system. Also, we would only recommend such a tax if the proceeds were used to reduce taxes elsewhere, restricting the net impact on most taxpayers.
- 2.53 We share the concerns raised in some submissions about the desirability of the OECD approach. The disadvantages of taxing capital gains on realisation would be particularly severe in the housing area. ‘Lock in’ of people to their current housing would impede labour market mobility. Taxation of capital gains would also be considered unfair by people forced to realise their housing gains to take up, say, better jobs, when no tax is levied on those fortunate enough to be able to change jobs without having to relocate. Overseas experience is that perceptions like these almost invariably result in the taxation of capital gains on owner-occupied housing being undermined by liberal rollover provisions or exemptions for principal residences.
- 2.54 Overseas experience also leaves us unconvinced by the OECD’s proposed approach to taxing imputed rental income. The OECD points to a number of other countries where imputed rental income is taxed: Belgium, Denmark, Luxembourg, The Netherlands, Norway, Poland, Sweden, Switzerland and Turkey. Our understanding is that imputed rental income is calculated in these countries at a very low rate. Since interest is deductible, the result tends to be an even greater tax concession than New Zealand has for owner-occupied housing.³³
- 2.55 The OECD proposal would also raise serious problems with separating expenses on repairs and maintenance from expenditures that enhance the value of the property. The fact that we currently have problems with taxing rented accommodation does not provide us with much comfort.

³¹ The total residential value excluding farms (obtained from Quotable Value NZ) multiplied by the proportion of housing stock that is mortgage free is \$125 billion.

³² “Saving Rates and Portfolio Allocation in NZ, Treasury Working Paper 99/9”; Household Economic Survey 1997/98.

³³ If the return on housing investment is deliberately undervalued it may be best simply to make interest deductible, as in the USA. While this would remove some of the arbitrary unfairness of New Zealand rules, it would be expensive and would considerably extend the scope of the existing concession. We therefore do not favour it.

A possible solution: application of the RFRM to housing

- 2.56 The RFRM provides a potential way of taxing returns to owner-occupied housing while avoiding the problems with the approach proposed by the OECD.
- 2.57 Under this approach, the annual opening value of a property for RFRM purposes could be based on property valuations undertaken for rating purposes. The taxable value would be reduced by the amount of any debt secured over the property. Mortgage interest would not be separately deductible. There would also be no need to deduct depreciation or repairs and maintenance expenses since the risk-free rate of return is assumed to be net of all expenses.

Example 2.1

David and Ruth own a house that is valued at \$200,000 and have a \$100,000 mortgage. David's marginal tax rate is 39 percent; Ruth's is 21 percent. The risk-free return (published by Inland Revenue) is four percent.

Taxable income in respect of the house is calculated as:

$$(\$200,000 - \$100,000) \times 0.04 = \$4,000$$

The taxable income is split evenly between David and Ruth. David's additional tax bill is \$780 while Ruth's \$420.³⁴

- 2.58 Example 2.1 assumes the tax liability would be split evenly between joint owners. However, taxing returns to owner-occupied housing, whether under the RFRM or any other approach, would create an incentive to transfer sole ownership of houses to lower tax-rate owners. Possible policy responses would be to allow this to occur or to apply a separate flat rate to housing. We would prefer that the tax system did not distort decisions about legal ownership.
- 2.59 All other things being equal, we would expect introduction of a tax to decrease the market values of owner-occupied houses, on the assumption that buyers will deduct the capitalised value of the tax from the amount they are willing to pay for a house. The effect is likely to be disproportionately higher at the upper end of the housing market, where buyers are generally less highly geared.³⁵ Work would have to be undertaken to

³⁴ Calculated as \$2,000 x 0.39 and \$2,000 x 0.21, respectively.

³⁵ Since the tax only applies to housing equity, the tax paid by buyers who are, say, 90 percent debt financed will be far less as a percentage of the value of a house than the tax paid by buyers who are, say, 50 percent debt financed. The average impact of a tax on a particular segment of the market would depend on how much the average buyer in the segment relied on debt.

determine the likely significance of these transitional effects on housing prices and to determine whether any transitional relief was warranted.³⁶

- 2.60 Owner-occupied housing does not generate cash flows that can be put toward paying a tax. In most instances, we do not believe this necessitates special treatment. However, individuals who own higher valued mortgage-free properties but have low incomes may have problems meeting the tax. This situation is more likely to arise among the elderly. At this stage, we are considering two, possibly complementary, solutions. The first would involve some form of targeted transitional relief, perhaps involving a partial or full exemption from the tax for some households. The second would be to provide that, in certain circumstances, tax could be deferred until a property was realised. We invite submissions on these points.
- 2.61 As we noted above, we strongly recommend that any tax on owner-occupied housing be introduced in a revenue-neutral manner, with the proceeds used to reduce other taxes. We return to this matter in the *Tax Mix* section later in this chapter.
- 2.62 How much revenue might a tax on owner-occupied housing raise? Based on figures obtained from Quotable Value and the RBNZ, with owner-occupied housing stock of \$125 billion³⁷ and housing debt associated with owner-occupied dwellings of \$50 billion, a base is available of approximately \$75 billion in net assets. At a risk-free rate of return of four percent, taxable income would be \$3.0 billion per annum. Taxed at an average income tax rate of 25 percent, this would generate about \$750 million per annum of revenue.
- 2.63 Application of the RFRM to just owner-occupied housing would require distinguishing owner-occupied housing from rental housing. This would sometimes be difficult; for example, where owner-occupied holiday accommodation is rented out when not occupied by the owner. This is already a difficult area of tax administration because a line needs to be drawn between private or domestic expenses and income earning expenses.
- 2.64 Concern is periodically expressed (normally when house prices are showing rapid capital gains, especially in Auckland) that a significant part of the anticipated return from rental housing investment is in the form of real capital gains. Because interest on a rented property is deductible, but gains are generally outside the tax base, these investments often show tax losses even where investors' expectation of a positive net return are realised. Annual returns filed with Inland Revenue by individuals show a decline in reported net profit from rental properties from \$213 million in 1993 to a net loss of \$24 million in 1999.

36 Our indicative calculations suggest the impact on housing values might range from a two percent reduction where the marginal buyer funded 90 percent of the purchase price with borrowed money to a 15 percent reduction where the marginal buyer relied solely on their own capital.

37 Quotable Value, Reserve Bank of New Zealand and Statistics New Zealand.

2.65 Applying the RFRM to rental as well as owner-occupied housing would both remedy this situation and prevent boundary problems between owner-occupied and rental housing.³⁸ The regime would therefore apply to residential housing.

Research and development

2.66 Compared to the OECD, New Zealand's private sector expenditure of research and development (R&D) is:

- low: 0.32 percent of GDP compared with the OECD average of 1.48 percent;
- growing rapidly: 6.2 percent growth between 1990-97 compared with the OECD average of -1 percent; and
- likely to be under reported relative to other countries, due to its less favourable tax treatment.

2.67 Other relevant facts are:

- the vast majority of R&D expenditure in New Zealand is on science provided by the public sector – 72.1 percent compared to the average of other OECD countries of 29.8 percent;
- the majority of the science capability in New Zealand is in the public sector;
- the New Zealand economy is dominated by low R&D intensity industries such as agriculture;
- the sectors that we would expect to have high R&D intensity (such as electronics) actually have a low R&D intensity, although technological leaders within these sectors have high R&D intensities; and
- New Zealand's level of acquired (imported) technology is high at 70 percent of the total technology embodied in output compared with the OECD, which ranges between 40 to 60 percent.

2.68 The government has recently moved to clarify the tax treatment of R&D expenditure, by applying the relevant accounting standard. The effect is that most expenditure on R&D will be able to be written off in the year it is incurred. This contrasts with 'normal' income tax treatment, where R&D expenditure that leads to the creation of an asset would be written off over the life of that asset.

2.69 We believe this move made sense within the context of the current tax system, since the previous boundary between what was deductible and what was not was unclear and arbitrary.

2.70 As we are less constrained by the current tax system than the government, we have gone back a step and asked a more fundamental question: what is the right tax treatment of R&D from a principled perspective?

³⁸ If it was adopted, we would envisage the RFRM applying to all housing, including property owned by non-residents and trusts. In the case of trusts, the obvious approach is to treat RFRM income as trustee income.

- 2.71 As we explained in Chapter One, *Frameworks*, we believe there should always be a strong presumption against extending concessionary treatment to any particular activity or sector, whether the concession is advocated on grounds of international competitiveness or for other reasons.
- 2.72 Thus, in the case of R&D, there is an argument that normal income tax treatment should apply. This would be our preference. If, however, the government were of the view that something more was required, we would caution against the automatic assumption that tax concessions are the most appropriate vehicle.

Wealth taxes

- 2.73 Wealth was one of the early bases relied on by governments for tax collection. In less developed societies wealth is more visible and easier to measure than other concepts such as income or expenditure. As economies become more complex and forms of wealth become less transparent and measurable, tax systems tend to move more towards income and consumption as their tax base. This has been New Zealand's experience. At the turn of the 19th century, the land tax (historically New Zealand's main form of wealth tax) made up 10 percent of government revenue. This declined to 0.1 percent until the land tax was abolished in 1992.³⁹
- 2.74 Nevertheless wealth is still used as a basis for tax by a number of OECD countries. Just over a third of OECD countries have some form of annual tax on personal wealth.⁴⁰ The taxes are characterised by high asset value thresholds, numerous exemptions, systematic under valuation of assets, complexity and low revenue collection (with a consequentially small impact on redistribution). In 1999, wealth taxes averaged less than one percent of total tax revenue in the OECD countries that had them.
- 2.75 The Review has considered whether it should further explore taxes on wealth. Submissions on the issue were divided. Some submissions argued a wealth tax would raise revenue and improve income and wealth distribution. Others pointed to overseas evidence that taxes on wealth raise little revenue.
- 2.76 Wealth taxes are economically equivalent to taxes on income.⁴¹ Consequently, if a wealth tax and an income tax are both applied to the same assets, the result is to increase the effective tax rate on those assets. And if the bases of the two taxes are not identical, as will invariably be the case, these composite effective tax rates will vary across assets, distorting savings and investment patterns.
- 2.77 A case can, however, be made for considering taxes on wealth where they would fill in gaps in the income tax base. To the extent that wealth is acquired by reinvesting after-

³⁹ L McKay, 1978, *Historical Aspects of the Estate Tax*.

⁴⁰ Finland, France, Iceland, Luxembourg, The Netherlands, Norway, Spain, Sweden and Switzerland have annual wealth taxes. See C Sandford, 2000, *Why Tax Systems Differ*, Fiscal Publications.

⁴¹ Both income taxes and wealth taxes reduced the after-tax rate of return to savings or 'wealth'.

tax income, it has already been recognised by the income tax system and there is no gap to fill. This suggests there is no need to pursue the idea of a general wealth tax.

- 2.78 Where wealth is acquired by inheritance, there could be more of a case for bringing it into the tax net by way of estate duty or a wealth transfer tax. However, even inherited income will be likely to have been accumulated out of income that was subject to tax and then employed to derive taxable income. The ‘filling in gaps in the income tax base’ rationale for a tax on wealth will therefore generally not apply in this case either.
- 2.79 New Zealand has in the past taxed inheritances by way of estate duty. Estate duty was first introduced in New Zealand by the Stamp Duties Act 1866. This imposed a graduated levy on both legacies and successions. At the turn of the 19th century, estate taxation accounted for 2.8 percent of total revenue collected. This climbed to 13.5 percent in 1915 and then fell to around one percent by 1975.⁴² By the time it was abolished in 1993, widespread avoidance meant estate duty accounted for only 0.3 percent of the total government revenue; that is, approximately \$80 million a year.
- 2.80 Again, an estate duty would not fill any existing gap in the income tax base. Moreover, as submissions note, New Zealand’s experience has been that it is difficult to enforce estate duty. Elderly New Zealanders, for example, can move to Australia where estate duty does not apply. We are therefore unconvinced that New Zealand could implement an effective estate duty even if this was considered desirable. The most likely result would be widespread avoidance that would undermine the integrity of the tax system as a whole.

Cash-flow tax

- 2.81 The proposal that the income tax be replaced with a cash-flow tax has received considerable academic endorsement and has periodically been proposed in other countries, though it has never been implemented.⁴³ We have examined the case for introducing a cash-flow tax in New Zealand.
- 2.82 The tax base under a cash-flow tax simply constitutes cash inflows less cash outflows. Under the most commonly considered method, financing cash flows – payment of interest and dividends, and the issue and repayment of debt and share capital – are disregarded. So, relative to a conventional income tax, a cash-flow tax has the conceptual advantage of not requiring complicated ‘timing’ or valuation rules. In addition, there is no need for rules dealing with the interface between a company and investors, such as imputation rules, rules dealing with dividends and the return of capital, rules dealing with interest expense and so on.

⁴² L McKay, 1978, *Historical Aspects of the Estate Tax*.

⁴³ C.f. Mead and Hall-Rabushka.

- 2.83 A cash-flow tax also has attractive theoretical properties. It effectively exempts from tax the risk-free return to capital,⁴⁴ resulting in an effective tax rate of zero percent on marginal investments. Consequently, the cash-flow tax does not distort investment decisions, results in a higher rate of return to savings and means New Zealand interest rates are not ‘grossed up’ by tax on non-resident investors, probably inducing higher investment.⁴⁵
- 2.84 These advantages are considerable, suggesting a cash-flow tax would be well worth pursuing were it not for three serious disadvantages. The first is that the transitional revenue cost of replacing the income tax with a cash-flow tax would be very high, in the order of several billion dollars annually. The reason is that it would, at a minimum, be necessary to continue allowing taxpayers depreciation deductions for their existing assets while at the same time allowing them to deduct the full amount of their gross investment.
- 2.85 Secondly, despite the high initial revenue cost, the value of some firms could fall markedly on introduction of a cash-flow tax, resulting in significant losses for their owners. This is because interest expense would not be deductible under the cash-flow tax and the capitalised value of foregone interest deductions would be very significant for highly geared firms.
- 2.86 Thirdly, no country has ever introduced a cash-flow tax. Irrespective of how simple a tax appears when described in a textbook, it can never be implemented in the real world without first resolving a considerable number of detailed design issues. These include anticipating and resolving the avoidance opportunities that inevitably arise with any real-world tax that collects a material amount of revenue. With the conventional income tax, we can benefit from considerable experience worldwide in resolving these practical issues. Because we would have no such opportunity under a cash-flow tax, implementing such a tax would involve a considerably larger act of faith than we are prepared to recommend the government take.
- 2.87 We consequently do not believe it will be possible in the foreseeable future to make a practical case for introducing a cash-flow tax. However, if another developed country was to introduce a cash-flow tax, its experience and approach should be monitored closely.

⁴⁴ To see why, note that the cost of an investment is immediately deductible under a cash-flow tax. Suppose the tax rate is 30 percent and the interest rate on government stock is 10 percent. Consider a taxpayer who purchases an asset for \$100 in year one and sells it for \$120 in year two. The taxpayer will receive a tax refund of \$30 in year one and will face a tax liability of \$36 in year two. If the taxpayer invested the tax refund in government stock, it would grow to \$33 by year two, leaving the taxpayer facing a net tax liability of \$3, equivalent to tax payable on the return to the asset in excess of the risk-free rate of return – that is, the difference between \$120 and the \$110 obtainable from investing in government stock.

⁴⁵ See Chapter Six, *International Tax: Taxing Income from Inbound and Offshore Investment*, for an explanation of how taxes on non-resident investors in New Zealand can affect interest rates.

Taxes on Expenditure and Transactions

Goods and services tax

- 2.88 Prior to the introduction of GST, the New Zealand tax base relied heavily on income tax and a wholesale sales tax. The wholesale sales tax applied varying rates to different products and contained many exceptions – most notably services. The narrow tax base meant that wholesale sales tax was not capable of raising significant revenue. It raised 3.76 percent of GDP⁴⁶ in 1984 compared with the 8.31 percent⁴⁷ of GDP now being raised by GST. The income tax system involved rates of up to 66 percent and had numerous exemptions. It was relatively easy for individuals to reduce their income tax liabilities and the high rates did not provide a good platform for raising additional revenue.
- 2.89 GST was introduced in 1986 as a means of broadening the tax base and lowering tax rates. GST taxes supplies of goods and services consumed in New Zealand. The broad-based, low-rate approach of GST is intended to raise revenue in a manner that is efficient and equitable. The broad tax base also reduces the extent to which GST affects consumption decisions.
- 2.90 Although not perfect, New Zealand's GST system has the advantage of a single rate and a comparatively broad base with few exemptions. This gives it a high level of effectiveness, reflected in the closeness of the effective GST rate (total value-added revenue divided by total consumption) to the statutory GST rate. In fact, measured this way, New Zealand's GST has the highest effectiveness of any value-added tax in the OECD.⁴⁸
- 2.91 The GST base is not, however, fully comprehensive. There are three ways in which a supply can effectively fall outside the tax base:
- where a supply is 'zero rated,' the supplier is not required to charge GST but can claim input credits, resulting in an effective GST rate of zero percent. Zero rating reflects deliberate policy decisions not to include certain items within the base. Exports are zero rated because, as a matter of policy, New Zealand imposes a destination-based GST on final consumption that takes place within New Zealand. Thus, imports are taxed at the border and exports are zero rated;⁴⁹

⁴⁶ According to the *New Zealand Official Yearbook 2000*, GDP in 1984 was \$34.839 billion. Inland Revenue's records show \$1.312 billion of sales tax assessed in that year.

⁴⁷ Source: IRD. GST raised \$8.46 billion in 1999/2000. (This figure includes both IRD and Customs GST, but excludes GST revenue from excise duties, customs duty, road user charges and motor vehicle registration fees.) 1999/2000 GST revenue inclusive of GST on the above items was \$8.871 billion. GDP in 1999/2000 was \$106.77 billion.

⁴⁸ OECD, 2000, *OECD Economic Surveys November 2000: New Zealand*, p 109, figure 32.

⁴⁹ The alternative approach, an origin-based approach, would tax all goods and services supplied in New Zealand. Here, exports would be taxed and imports would be zero rated. Economically, the two approaches are equivalent.

- where a supply is exempt, the supplier does not add GST to the selling price. However, unlike zero rating, suppliers of exempt goods and services cannot claim any input credits. The result is that inputs to the exempt good or service are taxed but value added by the supplier is not. So the effective GST rate on exempt supplies will reflect the ratio of input costs to final selling price, but will normally be closer to the statutory GST rate than to zero. The potential distortion from exemption is that suppliers have an incentive to undertake activities themselves, rather than purchase them from other suppliers and have to pay GST for which no input credit can be claimed. Major examples of exemptions are the sale of donated goods, financial services, housing and rental accommodation; and
- some activities are simply excluded from the GST base altogether. Examples are imported services sold direct to consumers or exempts, and owner-occupied housing. Imported services have a similar treatment to zero-rated services, in that GST is not included in the sale price and there is no prior New Zealand GST.

- 2.92 While owner-occupied housing and rental accommodation are subject to different rules, the substantive effect is equivalent: in both cases, costs incurred in constructing a house and ongoing running costs, such as rates, electricity, repairs and maintenance, are all subject to GST and input credits are unavailable. We therefore do not believe a case can be made for substantively amending the current treatment of rental accommodation.
- 2.93 In general, submissions were supportive of the broad-base low-rate approach, although the exemption of financial services from the GST regime was cited as an area of concern, as was the appropriate GST treatment of imported services.
- 2.94 In principle, financial services and imported services should be included within the GST base. Internationally, however, the GST treatment of financial services has proved an intractable problem. We are not aware of any developments that might allow progress to be made. While there are practical difficulties in regards to taxing imported services, and thus compliance costs can be an issue, the case for inclusion is strong.
- 2.95 The balance between revenue gathered through GST and other forms of taxation was a focus of many of the submissions. Some submissions preferred a greater revenue reliance on GST. Other submissions, however, viewed GST as regressive, arguing that the tax falls too heavily on lower- and middle-income earners. In these submissions, exempting necessary commodities – such as fruit and vegetables or electricity – was the most commonly posed solution to the perceived inequity.⁵⁰
- 2.96 While we appreciate the concerns raised in submissions, we consider that the regressivity of GST is often overstated. We note in this context research by the Treasury that found GST to be roughly proportional to income for the 80 percent of

⁵⁰ Several submissions advocated lowering the GST rate, abolishing GST or replacing it with a financial transactions tax. While the Committee does not propose recommending the adoption of any of these measures, it has considered the financial transactions tax in detail. This tax is discussed in this chapter.

households in the middle of the income distribution.⁵¹ The Treasury study concluded that introducing multiple GST rates or exemptions for commodities such as food and domestic fuel would have little effect on the overall incidence of GST, but would undermine neutrality and increase compliance costs. A similar conclusion was reached in a later independent study.⁵²

2.97 Because exemptions or lower GST rates for particular goods or services cannot be targeted just at lower income households, they are generally acknowledged as inefficient (and often ineffective) methods of achieving distributional objectives.⁵³ We are sympathetic with this view, which implies that distributional concerns are best addressed through expenditure programmes or the income tax system.

2.98 To conclude this section:

- we note that New Zealand's GST is widely regarded as establishing the international benchmark for taxes on goods and services;
- GST is, in our view, entirely consistent with the principles outlined in Chapter One, *Frameworks*;
- we do not believe a strong case can be made on either equity or efficiency grounds for either narrowing the GST base or for taxing some goods or services at lower rates; and
- we believe options for improving the GST treatment of financial services and imported services should continue to be explored.

Gift duty

2.99 Gift duty taxes transfers of property from one person to another in the absence of 'full' consideration. The application of the duty depends on the donor being domiciled or the property being domiciled in New Zealand. Duty applies where the total gifts in the year (previous 12 months) exceed \$27,000. Gift duty raises only a minor amount of revenue each year contributing only \$1.6 million in revenue in the 1999-2000 tax year. It does, however, require compliance with a registration process where the aggregate value of gifts in a 12-month period exceeds \$12,000.

2.100 Gift duty was originally introduced in 1910 to complement the estate duty rules. Its purpose was to prevent avoidance of estate duty by wealthy individuals transferring their assets to others late in life. When estate duty was abolished in 1992, gift duty

⁵¹ G Lewis, 1995, *An Analysis of the Distributional Impact of Cutting the Rate of GST*, Internal Treasury Working Paper.

⁵² J Creedy, "The Welfare Effect on Different Income Groups of Indirect Tax Changes and Inflation in New Zealand", *The Economic Record*, Vol 74, No 227, December 1995.

⁵³ In addition, overseas experience demonstrates that such measures significantly increase the compliance and administration costs of GST-type taxes and create difficult-to-administer boundaries between goods subject to different rates of tax. And exempting specific commodities distorts consumption patterns in favour of those goods while increasing compliance costs.

was retained. We understand gift duty was retained to buttress the social welfare system and to minimise taxpayers' ability to engage in 'income splitting'.⁵⁴

2.101 Submissions argue that gift duty should be abolished or, alternatively, the threshold at which duty applies should be increased.⁵⁵ Our view is that gift duty should, in principle, be abolished. In particular:

- its original rationale – buttressing estate duty – is no longer relevant; and
- where individuals have sufficient foresight to engage in regular gifting programmes, gift duty is of limited effectiveness as a defence against income splitting or avoidance of asset testing regimes. In any case, it would seem more logical to deal with the latter problem by bringing into welfare asset tests any assets transferred over the last half dozen years. This would seem to have the same effect as gift duty but with much lower compliance costs.

2.102 We are conscious, however, of two issues that should be considered before a final decision to repeal gift duty is taken:

- repeal would make it easier for wealthy people to transfer assets to trusts and have the income from those assets taxed at the trustee rate of 33 percent instead of at 39 percent. Our current view, however, is that alienation of assets in this way will increase over time whether gift duty is abolished or not, and that it is preferable to deal with this problem directly, by re-examining the relevant tax rates (see Chapter Four, *Tax Rates*); and
- gift duty also inhibits the wholesale transfer of assets into trusts to avoid creditors. Consideration would therefore have to be given both to the effectiveness of gift duty in this respect and to whether alternative measures should be introduced.

Stamp and cheque duties

2.103 Duties in their variety of forms are indirect taxes on transactions. Prior to 1988, stamp duty was used to tax agreements for sale and purchase of buildings, leases, and mortgages. The duty also applied to the transfer of shares and other deeds and instruments. After 1988 the scope of stamp duty was narrowed in its application. Stamp duty, with the exception of Approved Issuer Levy, was repealed in 1998.

2.104 Cheque duty is the one remaining transaction duty. Cheque duty is levied at a low across-the-board rate of five cents on each bill of exchange transaction. It raised \$11.5 million in revenue in 1999-2000 but is easily avoided as payments can instead be made in a non-dutiable form via cash or electronically, using credit cards, debit cards or direct payment authorisations. Credit card transactions were also subject to a transaction duty from 1981, but this duty was repealed in 1998.

⁵⁴ Gift duty inhibits individuals' ability to rapidly transfer income-producing assets to trusts or other individuals on lower marginal tax rates, whether to enhance eligibility for social welfare benefits or reduce tax liabilities.

⁵⁵ The current threshold of \$27,000 per annum was established in 1983.

2.105 Submissions have suggested that cheque duty be repealed. The arguments for this range from concerns that the duty is inefficient to administer and *ad hoc* in application, to it being distortionary to the tax system. We share these concerns and consider the anomaly of levying a duty on one payment form only should be remedied. While this could be achieved by levying duties on a broader range of transaction methods, we see no case for this approach and therefore favour repealing cheque duty.

Financial transactions tax

2.106 Several submissions proposed the replacement of GST by a tax on withdrawals from financial institutions. The premise behind this suggestion was typically that GST is regressive.

2.107 We accept that a financial transactions tax could in principle be implemented as an alternative to GST. However, we believe a financial transactions tax poses a number of significant problems that the current GST avoids.

2.108 On the face of it, a financial transactions tax has a very narrow base, applying to only a single activity – the withdrawal of funds from certain accounts. This is certainly the legal form of the tax. However, the economic impact of the tax is not on the withdrawal transaction itself but on the use – such as the purchase of goods or services – to which the withdrawn funds are put. Seen in this light, the base of a financial transactions tax is not so different to the current GST base.

2.109 This does not mean that a financial transactions tax is simply GST in another guise. Unlike GST, a financial transactions tax does not allow credits for the cost of inputs at intermediate stages of the production chain. Where GST taxes only the *value added* at each step, a financial transactions tax taxes the *full sale price* at each step. The result is that the effective tax rate, or tax component of the sale price, of a good will depend on the number of market transactions undertaken in the good's manufacture and sale.

Example 2.2

Suppose the government introduces a financial transactions tax at a rate of five percent.⁵⁶

ABC Co manufactures ice cream and sells its entire output through its own chain of ice cream parlours. ABC Co annually buys inputs costing \$100 and sells its output for \$200.

Tax payable in respect of ABC Co's output is:

Cash withdrawn to pay for ABC Co's inputs: $5\% \times \$100 = \5 .

- Cash withdrawn by customers to pay for ABC Co's ice cream: $5\% \times \$200 = \10 .
- Total tax is \$15. The effective tax rate on ABC Co's output is $15 / 200 = 7.5$ percent.

⁵⁶ This rate is selected solely for the purposes of the example. It is not necessarily representative of the rate that might apply under a real-world financial transactions tax.

XYZ Co is a competitor of ABC Co. However, XYZ Co does not have its own chain of ice cream parlours and instead sells its output to third party retailers. XYZ Co also annually buys inputs costing \$100 but sells its output for \$150. The retailers who buy XYZ Co's output sell it for \$200.

Tax payable on XYZ Co's output is:

- Tax on cash withdrawn to pay for XYZ Co's inputs: $5\% \times \$100 = \5 .
- Tax on cash withdrawn by retailers to pay for ice cream: $5\% \times \$150 = \7.50 .
- Tax on cash withdrawn by consumers to pay for ice cream: $5\% \times \$200 = \10 .

Total tax payable on XYZ Co's output is \$22.50, for an effective tax rate of $22.5 / 200 = 11.25$ percent.

2.110 The way in which the effective tax rate increases with the number of transactions is known as a 'cascade effect'. The cascade effect has three important ramifications:

- since effective tax rates depend on the number of market transactions involved in producing a good or service for final sale, it is virtually impossible to estimate the likely pattern of effective tax rates across different goods and services. This means it is impossible to form a view on the likely progressivity (or regressivity) of a financial transactions tax;
- a related point is that it is almost impossible to estimate with reasonable accuracy the revenue consequences of any particular financial transactions tax rate. We are sceptical of the calculations that we have seen because they ignore the cascading effect. At the same time, we are not confident that we can give a more reliable estimate of the rate that might be required if the GST was to be replaced by a financial transactions tax; and
- the market prices of goods that embody numerous production links would be artificially inflated relative to those that require few production links, which is an economic distortion of precisely the kind that we wish to avoid in our approach to tax reform.

2.111 We do not recommend further consideration of financial transactions taxes.

Tobin tax

2.112 The Tobin tax is a low-rate tax levied on all foreign exchange transactions to dampen currency speculation. We discuss the Tobin tax here because a number of the submissions we received raised issues relating to the Tobin tax and the financial transactions tax together. These two taxes are often confused.

2.113 The premise behind the Tobin tax is that currency speculation is a significant contributor to exchange rate fluctuations and that reducing speculation will stabilise exchange rates. A speculator will tend to move funds into and out of currencies and so will make a number of trades in a year. Thus even a small rate of Tobin tax per trade

can accumulate to a significant amount of tax per year. This will reduce the profit from currency speculation and so less speculation will occur.

2.114 We believe that the goal of reducing exchange rate fluctuations by reducing speculation is misguided, and in any case we are not convinced that a Tobin tax will have any real effect on speculation in practice. In particular, we note that:

- unilateral Tobin-type measures are likely to be largely futile because speculators in the local currency need not deal in the local foreign exchange markets. A speculator in the New Zealand dollar need not be a New Zealand resident (indeed most will not be), and can take a position in the New Zealand dollar without being subject to the tax by dealing in New York or London;
- we are of the view that currency speculation is a necessary aspect of trading that reduces the exchange rate risks of importers and exporters who do not want to cope with the exchange rate fluctuations in their businesses. Importers and exporters protect themselves through currency hedging deals, avoiding exchange rate risks by doing so. This leaves the risks with other currency traders, who may be far removed from New Zealand, and who gamble on the direction of currency movements; and
- a Tobin tax, to the extent that it was paid in New Zealand, would make hedging more expensive in New Zealand, reduce the amount of it and expose importers and exporters to more exchange rate risk.

2.115 We have therefore concluded that there is not a strong case for introducing a Tobin-type tax in New Zealand.

Excises and duties

2.116 In 1876 excises and customs duties provided over 90 percent of all New Zealand tax revenue. This proportion has fallen steadily over time.⁵⁷ Today, after including customs duty and the GST on excises and duties, the excises on alcohol, tobacco and petrol, and the duties on gaming raise about \$2.8 billion.⁵⁸ This is equivalent to about 8.3 percent of total tax revenue, about one quarter of total indirect tax revenue and about one third of GST receipts net of the GST induced by the excises.⁵⁹ Expressed on a 'GST-equivalent' basis, the total rate of indirect taxation in New Zealand is therefore of the order of 16.6 percent.⁶⁰

⁵⁷ Taxation Review Committee, 1967.

⁵⁸ This figure is adjusted for the total of Table 2.1.

⁵⁹ Induced GST was \$322 million so that GST net of GST induced by the excises was \$8.5 billion and $2./8.5=0.3$.

⁶⁰ Because the consumption tax base providing net GST revenue of \$8.5 billion may be estimated at \$68b ($8.5/68=0.125$), it follows that the "GST-equivalent" rate of total indirect taxation is of the order of 16.6 percent: $(8.5+2.8)/68=0.166$.

2.117 The narrowly based excises and duties are of interest to the Review because of the large amount of revenue they raise and for the challenge they pose to the broad-based low-rate rationale underpinning other parts of the New Zealand tax system. The close link between the rationales offered for these existing excises and some new directions proposed for the tax system was noted in some submissions.⁶¹

2.118 Excises and/or duties are imposed on four categories of spending: alcoholic beverages, tobacco, gaming and petrol. The excises on *domestic production* of alcohol, tobacco, and petrol are matched by corresponding customs duties on imports to ensure that the tax base is *domestic consumption*. Excise revenues quoted below include these matching customs duties. In addition, because the base of the GST includes excises and duties to the extent they are included in the final price (GST is levied last), GST revenue is higher than it would be in the absence of excises and duties. This additional GST is termed ‘induced’ GST.

Revenue from excises and duties

2.119 The table below shows the distribution of the revenue raised by the excises and duties across the four expenditure groups.

Table 2.1 – Composition of Excise Receipts (Fiscal 1999/2000)

	Excise/Duty	Customs Duty	Induced GST	Total	Adjusted Total
Alcohol	\$416m	\$102m	\$65m	\$583m	\$583m
Tobacco	\$804m	\$43m	\$106m	\$953m	\$1,063m
Gaming	\$176m	–	\$20m	\$196m	\$507m
Petrol ⁶²	\$639m	\$390m	\$129m	\$1,158m	\$630m
TOTAL	\$2,035m	\$535m	\$320m	\$2,890m	\$2,783m

2.120 The “adjusted total” in the final column of Table 2.1 reflects the following adjustments:

- tobacco excise was increased by an amount equivalent to \$1 per packet of cigarettes on 10 May 2000. We have assumed a full year impact of \$110 million;
- the inclusion of estimates of additional implicit regulatory taxes on gaming in respect of the monopoly position of the Lotteries Commission (\$130 million) and non-casino gaming machine returns hypothecated directly to ‘charitable’ purposes

⁶¹ A number of submissions combined enthusiasm for the intensification of excise taxation with identification of suitable cases for similar treatment.

⁶² Excise/customs duty – excise figures are adjusted for customs duty generally reported as excises.

(\$150 million).⁶³ Adjusted for GST, these implicit taxes represent a further \$311 million of indirect taxation;⁶⁴ and

- exclusion of the portion of excise on petrol that matches the directly levied road user charges on diesel vehicles, which pay no excise. When only the 21c/litre going to general revenue is included, the total excise component for petrol falls by \$528 million to \$630 million.

2.121 While these adjustments affect the allocation of excise taxation across the categories, they leave the total broadly unchanged.

Table 2.2 – Excise/Duty Rates and Bases (Statutory)

Item	Rate	Base	Comment
Spirits	\$36.307	Per litre alcohol	Specific rate, indexed to the CPI
Beer and wine	\$19.935	Per litre alcohol	Specific rate, indexed to the CPI ⁶⁵
Cigarettes	\$246.95	Per thousand	Indexed to the CPI
Petrol	34.3 cents	Per litre	Specific rate but not indexed. 21 cents goes to consolidated fund
Gaming duty	20%	Operator win (net consumer spend)	Applied for non-casino gaming machines and sports betting, and about this rate for race and sports betting ⁶⁶
Casinos	4%	Casino win	
Lotteries	5.5%	Commission's turnover	

2.122 Table 2.3 summarises on a consistent basis the impact of excises for an indicative range of commodities, taking into account the GST impact.

⁶³ Department of Internal Affairs, 2001, *Gaming Reform in New Zealand*.

⁶⁴ No adjustment has been included for the statutory monopoly position of the TAB or for the effects of the temporary moratorium on entry by new casinos (due to expire on 15 October 2003). It is noted that the \$70 million per annum paid by the TAB to race clubs (and also to other sports) supports the production of the events on which race (and sports) betting is conducted. No firm basis exists for estimating the implicit tax on consumers implied by the casino moratorium.

⁶⁵ The effective alcohol-equivalent rate for wine appears rather lower than the rate for beer since the excise is applied per litre of beverage at an assumed 10 percent alcohol content.

⁶⁶ The effective rate for race betting is lower than the 20 percent on account of the exclusion of GST, the "fractions" arising as payouts are rounded down, and unpaid dividends from the statutory base of the gaming duty. The base is therefore smaller than the amount of expenditure by consumers.

Table 2.3 – Illustrative Breakdown of Prices

Commodity	Base Price	GST on Base Price	Excise/Duty (GST-adjusted)	Consumer Price	Excise/ Duty Rate (on Consumer Price)	Excise/Duty Rate (on Base Price)	Full Tax Rate (on Base Price)
Beer (1doz 330ml, 4% abv)	\$11	\$1.38	\$3.56	\$16	22%	32%	45%
Wine (750ml) ¹	\$12	\$1.50	\$1.70	\$15.20	11%	14%	27%
Spirits (1125ml 37.2% abv) ¹	\$15.80	\$1.98	\$17.09	\$34.87	49%	108%	120%
Cigarettes (20)	\$2.50	\$0.31	\$5.56	\$8.37	66%	222%	235%
Petrol (litre) ²	\$0.81	\$0.10	\$0.21	\$1.12	19%	26%	38%

Notes

¹ Estimated *ad valorem* rates are highly sensitive to assumed quality as reflected in the illustrative base price.

² Includes only the general revenue component of the excise.

2.123 Effective *ad valorem* rates for gaming duties are also highly variable. Gaming duties take, on average, 15 cents in each dollar of gambling expenditure or (at least) 40 cents when the implicit regulatory taxes are included. But because of variations in the bases and rates of the gaming duties, the GST-adjusted tax take ranges from 4.4 cents per dollar of consumer expenditure for casinos, through 14 cents for lotteries, 19 cents for racing and sports betting, to 22.5 cents for non-casino gaming machines. Adding the effect of implicit regulatory taxes raises the estimated tax take to 59 cents in the dollar for expenditure with the Lotteries Commission and to 74 cents in the dollar for non-casino gaming machines.⁶⁷

Are excises efficient revenue raisers?

2.124 New Zealand Budget documents reveal that, prior to the 1970s, the excises and duties were seen as revenue raisers and it appears likely that the very significant contribution of excises to revenue is a major explanation for their persistence. But are excises a low cost option for raising revenue?

2.125 Economists often recommend that to raise revenue most efficiently (that is, to minimise excess burden), tax rates should be highest on goods with the most inelastic demand (so-called ‘Ramsey taxation’). Of the goods subject to excise, petrol, tobacco

⁶⁷ These estimates are derived by including the percentage of consumer expenditure that funds the charitable contributions made by the Lotteries Commission and allowing for the regulatory 33 percent of win that must be devoted to charitable purposes by those licensed to operate non-casino gaming machines.

and beer appear to offer the most inelastic tax bases while the demand for gaming and for wine and spirits is often estimated to be rather more responsive to price changes (that is, more elastic).

2.126 Box 2.1 contains illustrative estimates of deadweight costs associated with current excises and duties. Many of these taxes appear to be associated with high deadweight costs per dollar of additional revenue raised relative to broadly based forms of taxation (where marginal deadweight costs in the range of 14-24 cents per dollar of net revenue raised are found in most studies). While the estimates in Box 2.1 can be no more than illustrative, they suggest that it is not possible to justify current levels of excises and duties on 'efficient taxation' grounds.

Box 2.1 – The Marginal Excess Burden of Excises

In Chapter One, *Frameworks*, we noted that the deadweight cost (or 'excess burden') imposed on taxpayers was the difference between:

- the amount a taxpayer would be willing to pay to escape imposition of the tax; and
- the net amount of tax actually collected.

An *increase* in a tax will raise less revenue than otherwise as taxpayers respond by altering their behaviour. 'Marginal excess burden' measures this revenue shortfall.

A rough guide used to estimate this fall in revenue (as a proportion of the additional tax that would be collected at unchanged behaviour) is:

- the tax rate (expressed as a proportion of the tax inclusive price); multiplied by
- the elasticity (or measure of responsiveness), with respect to this price, of the tax base.

For example, suppose tax is levied at the rate of 25 percent of the tax inclusive price on a commodity with a base elasticity is unity (that is, demand falls by one percent for a one percent increase in price).

The marginal excess burden of this tax will be equal to one quarter of the extra tax (the marginal burden) that would be raised by a (small) tax increase, if the behaviour of taxpayers did not change. This means that for a net 75 cents of additional tax, 25 cents was 'lost' as the tax base shrinks in response to the tax increase. That implies a loss of 33 cents for each dollar of net revenue. The additional economic cost of raising a dollar of extra revenue is therefore 33 cents.

- For tobacco taxation, where the tax inclusive excise rate is 66 percent and the elasticity of demand is estimated to be 0.5, marginal excess burden is equal to a third of the marginal burden ($0.66 \times 0.5 = 0.33$) or approximately 50 cents per dollar of additional net revenue.
- For non-casino gaming machines where a demand elasticity of 0.8 has been estimated in New Zealand and where the combined effect of gaming duties and regulatory taxes is 60 percent of win, marginal excess burden would be in excess of 90 cents per dollar of net revenue raised.
- For spirits, if the elasticity is 1.2 and the excise is 50 percent of the tax inclusive price, marginal excess burden would be 150 percent of net revenue raised.

- 2.127 These estimates are illustrative since, for most commodities, ‘own’ elasticities, such as those used above, vary considerably among studies. Moreover the ‘cross’ elasticities needed to refine the approach to take account of tax base interactions are even less reliable.
- 2.128 It is for these reasons that fine tuning of commodity taxes to minimise excess burden is rejected in favour of the broad-based flat-rate approach to indirect taxation observed in the GST. Moreover, it is widely recognised that exploitation of demand elasticities to minimise deadweight costs can only be justified where patterns of consumption across the population of taxpayers allow serious horizontal and vertical inequities to be avoided. We turn to equity considerations below.
- 2.129 The Review does not believe that revenue raising provides a sustainable rationale for narrowly based indirect taxes in the modern-day environment where GST offers an alternative form of consumption taxation. Unlike the excises, GST has the attractive property that its very broad base and single rate makes the revenue it raises independent of how people choose to spend their money.⁶⁸

The equity impact of excise taxes and gaming duties

- 2.130 We noted in Chapter One, *Frameworks*, that the *economic* incidence of taxes is not necessarily the same as the *legal* incidence of taxes. However, the nature of the markets for alcoholic beverages, tobacco, and petrol, together with the design of the taxes, is such that we are confident these taxes mainly result in higher prices to consumers.⁶⁹
- 2.131 The base-line assumption of full forward shifting to consumers is, however, not appropriate in the gaming industry, where monopoly privileges and government regulation can be expected to raise prices to consumers independently of explicit gaming duties. Consequently, changes to gaming duties can be expected to partly fall on charitable contributions.
- 2.132 Excises will be horizontally inequitable if they result in tax burdens that vary significantly with consumers' spending patterns. The extent of horizontal inequity can be gauged by looking at spending patterns and the size of the relevant taxes (see Box 2.2 below).

⁶⁸ It is sometimes argued that the excises have low compliance costs. However, the *marginal* costs of collection for the GST should be lower again.

⁶⁹ The New Zealand markets for alcoholic beverages, tobacco, and petrol are highly concentrated among small numbers of producers. However, the markets are open to import competition and the excises and corresponding customs duties are specifically integrated to uniformly tax consumption. These features strongly support the presumption of forward shifting.

Box 2.2: Excise Tax Burdens

Around 25 percent of the adult population smoke.⁷⁰

With the excise at \$5.56 per packet, a smoker consuming a packet per day⁷¹ pays over \$2000 per annum in GST-adjusted tobacco excise.

Around 87 percent of adult New Zealanders consume alcohol.⁷²

- drinkers on average pay \$225 per annum each in alcohol excise;
- 50 percent of drinkers pay around 90 percent of the excise, on average \$400 each per annum; and
- the top 10 percent of drinkers – around 260,000 individuals – on average pay \$1100 per annum in alcohol excise.

Some 86 percent of New Zealanders gamble.⁷³

- gamblers on average spend about \$490 per annum on gambling;
- 53 percent of adults spend less than \$240 per annum; and
- ‘regular continuous gamblers’ – 10.5 percent of adults – spend an average of \$1800 per annum. At an average tax rate of 40 cents in the dollar of gambling expenditure, these 300,000 New Zealanders would pay on average \$700 per year in gaming taxes.⁷⁴

2.133 Box 2.2 suggests that many New Zealanders of modest means will pay as much or more indirect tax via alcohol and tobacco excise and gaming duties as they pay in GST levied on all of their spending. As noted earlier in the context of the efficiency of excise taxes, the Review considers that differences of this size in indirect tax burdens are very difficult to justify.⁷⁵

2.134 The Review recognises that although the great majority of New Zealanders enjoy drinking and gambling in moderation, a number have difficulty in coping with the consumption of these commodities, and a small number experience acute problems as

⁷⁰ See Ministry of Health, May 1999, *Tobacco Facts*.

⁷¹ Median consumption per smoker is 15 cigarettes per day with 46 percent smoking between half and one packet a day and 14 percent smoking more than a packet a day.

⁷² 87 percent is the proportion consuming some form of alcohol in the previous 12 months (see Alcohol and Public Health Research Unit, 1996, *Drinking in New Zealand: A National Survey 1995*).

⁷³ 86 percent is the proportion of adults participating in some form of gambling in the past six months. About 41 percent participate weekly. Abbott M.A. and R.A. Volberg, June 2000, *Taking the Pulse on Gambling and Problem Gambling in New Zealand: A Report on Phase One of the National Prevalence Survey*.

⁷⁴ *Op cit*, p 3. Applying the average rate of explicit and implicit gaming duties of 40 cents in the dollar of gaming expenditure to this figure would suggest that 10 percent of adults pay an average of \$720 in gaming taxes per annum. The large variation in tax rates across different types of gambling suggests that this figure is likely to overstate the tax burden borne by this group.

⁷⁵ In the same way, these levels of tax horizontal discrimination raise serious problems in judging the adequacy of benefit levels. Are benefits inadequate for the many beneficiaries who smoke, drink and gamble? Or are they excessive for those who do not?

a result.⁷⁶ We are aware of, and strongly support, the dedicated health services assisting these people to overcome their problems.

2.135 However, we consider that a particularly disturbing aspect of the alcohol and gambling excises is their disproportionately severe impact on the minority of individuals and families who experience drinking or gambling problems.

2.136 The link between increased taxation and increased harm appears clear in the case of problem gamblers whose problems will be more closely related to their level of gambling expenditure than to the level of the activity itself (gambling turnover). Although the demand for gaming is sometimes estimated to be price elastic in aggregate,⁷⁷ demand among problem and pathological gamblers can be expected to be highly inelastic. For problem gamblers, gambling expenditure, and its associated problems, can be expected to rise as taxes are raised.

2.137 Excise taxation is commonly believed to be regressive since these commodities are thought to represent a smaller proportion of household budgets the higher the income decile. While this appears strongly confirmed for tobacco, for the other commodities available evidence shows a more complex picture:⁷⁸

- the 1996/97 New Zealand Health Survey strongly confirms a presumption of regressivity in the case of tobacco since it shows smoking prevalence to be essentially independent of family income (except above \$50,000 where it is lower at 20 percent) while smoking intensity shows no statistically significant differences across family incomes;⁷⁹
- expenditure on alcohol appears to increase with household income. In the 1997/98 Household Economic Survey, expenditure rises from around 1.85 percent of household expenditure in the bottom two quintiles to 2.79 percent in the top quintile, suggesting that the incidence of alcohol taxation is progressive;
- gambling expenditure represents only 0.26 percent of household expenditure in the lowest quintile but is much higher across the remainder of the distribution (0.77, 0.73, 0.86 and 0.62 percent across quintiles two to five); and

⁷⁶ For example, the 1999 estimate of problem and pathological gambling prevalence in New Zealand was 1.9 and one percent of the adult population respectively, with 1.6 percent considering that they have had a gambling problem in the past and half a percent of adults considering that they have a current gambling problem. See Abbott M.A. and R.A. Volberg, June 2000, *Taking the Pulse on Gambling and Problem Gambling in New Zealand: A Report on Phase One of the National Prevalence Survey*, p 7.

⁷⁷ See New Zealand Lotteries Commission, April 1997, *Responsible Gaming*, p 30.

⁷⁸ Evidence on spending patterns is subject to the *caveat* that while alcohol, tobacco and gaming expenditure is known to be understated in the Household Economic Survey, it is not known how this bias varies across the income distribution. For alcohol and gambling, differences in duty rates make it difficult to infer tax incidence from data on expenditure.

⁷⁹ A troubling aspect of the incidence of tobacco taxation follows from the dramatically higher smoking prevalence among particular groups. In the 1996/97 New Zealand Health Survey, smoking prevalence was found to be highest at 36.8 percent among the most deprived, falling to 15.7 percent among the least deprived. Smoking intensity was not found to be related to NZDep96 score. Smoking prevalence among Maori is twice that of the population at large, while prevalence among sole parent with dependent children households is also very high at about 42 percent.

- expenditure on petrol accounts for about three percent of household expenditure in the two lowest quintiles, rising to 3.45 percent in the third quintile and falling to 2.84 percent in the top quintile.
- 2.138 Some of the submissions noted the regressivity of the tobacco excise but sought to dismiss this by quoting the World Bank's argument in relation to tobacco taxation that policymakers should be concerned with the "*...distributional impact of the entire tax and expenditure system, and less on particular taxes in isolation*".
- 2.139 While we agree that it is the combined impact of the tax and expenditure systems that is relevant when assessing redistribution, there appear to be no feasible changes to other forms of taxation or expenditure that can redress the horizontal inequity created by the excises. Moreover, the large horizontal inequities created by the excises make the average taxes paid by abstract income deciles a very unreliable guide to the impact of taxes on particular individuals and families within those groups.

User charges and externalities

- 2.140 Because excises fare poorly on the conventional tax policy criteria of efficiency in revenue raising and equity, the Review considers that they require very strong alternative justification.
- 2.141 The excises and duties are nowadays recommended as a means of promoting healthier lifestyles, as charges for the use of the health system or as a means of correcting a variety of other 'market failures' (the externality justification).
- 2.142 The listing of potential externalities (fire, litter, public disorder, road trauma, air pollution, traffic congestion) associated with the consumption of these commodities is often accompanied by recognition that taxation at the national level is poorly targeted at these forms of market failure. Excises are, of necessity, uniform across units of consumption of the taxed commodities. External damage, on the other hand will typically not be uniformly mixed. This places the tax system at the opposite end of the spectrum to targeted intervention such as regulation, or fines and sentences imposed through the courts, which are capable of being closely calibrated to the source and degree of the harm.⁸⁰ The Review believes that targeted intervention, rather than national taxation is the preferred approach to dealing with most external effects.

⁸⁰ It appears that drink driving has responded to targeted intervention. Road accidents in which drink driving was a contributing factor have fallen by 50-60 percent over the past decade in response to a range of targeted measures. However not all "external" harm has been eliminated. The Land Transport Safety Authority claims that in 1999, in addition to themselves and their own passengers, "drunk drivers were responsible for killing 18 other drivers, passengers, cyclists and pedestrians". See www.ltsa.govt.nz/research/drink.html.

Social spending externalities

- 2.143 Excises are sometimes recommended as effective instruments of lifestyle modification, in pursuit of improved public health outcomes to meet health system targets.⁸¹ The Review has received submissions supporting a programme of "regular and substantial increases in tobacco excise" on these grounds.
- 2.144 For both alcohol and tobacco, the New Zealand public health system was seen in some submissions as an important source of external costs suitable for correction by taxation. If additional medical expenses incurred by smokers and drinkers are paid for by the individuals themselves (as occurs in part in New Zealand), they will be factored into decisions about smoking and drinking. This will not be true where health services are provided free of charge by the state (or where private health insurance premiums are unrelated to lifestyle choices).
- 2.145 The resulting problem is called moral hazard – peoples' decisions will not reflect the full costs of their lifestyle choices if someone else is meeting those costs.⁸² This reasoning suggests smokers and drinkers will not have adequate regard to their medical costs and other burdens placed on the taxpayer.⁸³
- 2.146 Though we recognise these concerns, we remain unconvinced that they provide a robust basis for tax policy. In reaching this conclusion, we have asked ourselves the following questions:
- ***Do people understand the risks?*** Decisions to smoke, drink, gamble or drive all involve the acceptance of well publicised risks. In other spheres, people are left to make their own choices about a variety of potentially hazardous activities without undue intervention by the state. In fact, the widely accepted approach to tax design is to seek to minimise differences in tax treatments among substitutable goods and services on the grounds that overall community welfare will be enhanced if people are left to make decisions on the information best known to them, without the intrusion of the tax system;
 - ***Why address the problem of moral hazard in the case of smokers and drinkers but not in other cases?*** It is difficult to make a convincing case for using specific taxes to fund health-related costs attributable to smoking and drinking but not using specific taxes to fund costs attributable to other types of risky behaviour. The public health rationale for excise taxes on tobacco products and alcohol would

⁸¹ As recommended by the former Public Health Commission, which promulgated regular and substantial increases in excise rates as a means of reaching its "1000 by 2000" target. This aimed to reduce tobacco consumption to 1,000 cigarette equivalents per adult by the year 2000 (Public Health Commission, March 1995, *Tobacco Taxation as a Health Issue: Discussion Document*). See also Ministry of Health, 1998, *Progress on Health Outcomes*, p 63.

⁸² Moral hazard arises when insurance against risks weakens the incentive to take precautions to prevent them. A common response is co-insurance (partial coverage of risks). Co-insurance also occurs under the public health system since many of the costs of ill-health are met privately.

⁸³ For example, the Treasury has argued that "we would want tobacco taxes to be somewhat beyond the level where they recovered tobacco-related use of public health facilities. Beyond that we think it is a matter for the government". The Treasury, April 1991, *Taxation of Alcohol and Tobacco*, pp 4-5.

appear applicable to any activity or consumption choice that might be subject to moral hazard problems, such as contact sports, health-related diet and exercise issues, or abstention;⁸⁴ and

- ***Can the social spending argument reasonably be limited to excess health costs?***
One submission noted that "*The World Bank ... also reports that there are recent reviews which suggest that smokers have higher lifetime medical costs despite their shorter lives*". This suggests that the timing of additional health expenditures incurred on behalf of smokers will be important for assessing these external costs. It also suggests that an exclusive focus on health costs, to the exclusion of the impact on lifestyle choices on other areas of social spending, is unlikely to be justified.⁸⁵

2.147 New Zealand provides universal national superannuation at age 65. At age 20 the average New Zealander can expect to enjoy 13 years in receipt of National Superannuation (at the rate of \$13,000 pa) implying that, at a 5 percent real interest rate, the value at age 65 of the superannuation annuity expected to be required at age 20 is \$124,000. Since a lifetime smoker's life expectancy at age 20 is of the order of seven years lower,⁸⁶ the value at age 65 of the annuity required at retirement age to fund a smoker's expected superannuation is only \$67,000. Many would think that the difference between these amounts provides a sizeable allowance, independently of tobacco excise, to fund differences in public health costs attributable to smoking.⁸⁷

2.148 We emphasise again that the Review is not attracted to social spending arguments as a basis for corrective tax policy. In our view a more sensible and consistent approach would accept moral hazard as part of the price of the public health system. The alternative (and current) approach is clearly selectively applied and is inequitable, since it results in significant discrimination between those whose excess health costs are subject to a user charge and those whose excess health costs are not.

⁸⁴ Increasing medical evidence indicates that many people could lower public health system costs by raising their alcohol consumption to the 'regular and moderate' level of one to two drinks per day.

⁸⁵ The Review is aware of US studies that estimate the external costs of collectively financed programs. These studies include health system costs, nursing home costs and pension costs and allow for the timing of the incidence of these costs (see, for example, Manning, Willard G. et al., 1991, *The Costs of Poor Health Habits*, Harvard University Press and Viscusi W. K. "Cigarette Taxation and the Social Consequences of Smoking", in Poterba J.M. ed., 1995, *Tax Policy and the Economy*, M.I.T. Press). While we acknowledge the logical force of the approach, we do not believe that compensating intervention provides a robust basis for tax policy.

⁸⁶ See Ministry of Health, May 1999, *Tobacco Facts*, where it is claimed that: "*The risk of early death is one in two for the individual smoker who continues to smoke through adulthood. Those who die early from smoking die on average 14 years early.*"

⁸⁷ These excess costs are claimed to be of the order of \$220 million in current dollars. This estimate includes elements of private costs (for example, GP costs) and incorporates no allowance for the timing of these costs.

2.149 While the alcohol and tobacco excises are routinely referred to in official documents as correcting externalities, the Review has received no estimates of the rates of tax that are implied by this approach to taxation.⁸⁸ We are, however, interested in further evaluating its methodological and empirical basis.

Ideas and questions we'd like you to consider

- Excises and duties appear to be predominantly passed on to consumers.
- At current rates many of these taxes appear to be inefficient revenue raisers.
- Patterns of consumption suggest that they impose large horizontal inequities, and we view with concern the heavy burden of these taxes on a large minority of (often low income) New Zealanders.
- While the Review is not attracted to the social spending argument as a basis for tax policy, we seek further consultation on this approach. What limits should apply to the use of taxes and subsidies to minimise public health costs? Should user charges take account only of health costs or are differential demands on other forms of social spending, such as state-provided pensions, also relevant in designing an equitable system?
- We strongly support educational programmes informing users of the risks of smoking, drinking and gambling and assistance targeted at helping problem drinkers and gamblers to overcome their problems. These are typical responses to public health issues. What makes exclusive reliance on these approaches inappropriate for these problems?

Road transport externalities

2.150 In evaluating the petrol excise, the Review sought to account for the 21c/litre (\$630 million total) general revenue excise on petrol and the absence of any corresponding charge on diesel.⁸⁹

2.151 Road user charges paid by diesel (and heavy petrol) vehicles vary with distance driven and vehicle weight and appear targeted at road use and road damage caused by that use. Revenues raised (\$507 million in 1999/2000) pass via the National Roads Fund to Transit New Zealand. The further \$177 raised by motor vehicle registration fees (which also flows through to roading) is unrelated to road use, but could be justified as an overhead charge on motorists that permits user charges to be more closely related to the *marginal* costs of road use.⁹⁰

⁸⁸ Some submissions drew attention to the very large difference between the rate of excise applying to spirits and that applying to other alcoholic beverages. The Review has not been provided with any rational explanation of this discrepancy and we can see no justification for it.

⁸⁹ In principle, diesel could be subject to excise, or the equivalent of 21c/litre could be limited to diesel used on roads by incorporating it into road user charges. Note that diesel accounts for around 30 percent of total fuel used in road transport, while about 70 percent of all diesel is used in road transport.

⁹⁰ This "two-part pricing" explanation justification is, of course, difficult to sustain for petrol vehicles, in the face of the general revenue component of the petrol excise which works to raise costs of road use.

- 2.152 Light petrol vehicles are not subject to road user charges. However, a portion of the revenue from petrol excise and duty (corresponding closely to the road user charge) goes to the Roads Fund. This portion covers road use by light petrol vehicles and does so with presumptively lower compliance costs. In practice, the direct link between these road user charges and the roads they fund will provide a useful reality check on the level of these taxes. Such checks can be missing in taxes that are justified as internalising less tangible external costs.
- 2.153 The Ministry of Transport, *Land Transport Pricing Study*, provides estimates of environmental costs of \$990 million associated with the road transport network in the areas of water quality (\$100 million), noise pollution (\$290 million), and air quality (\$700 million).⁹¹ However, this study explicitly avoided translating these estimates of external costs into specific tax policy recommendations.⁹²
- 2.154 After reviewing these external cost estimates (see Annex E for details), our preliminary conclusion is that the evidence for generalised environmental noise and air quality externalities assembled by the study is too speculative to provide a firm basis for the 21c/litre general revenue excise levied on petrol or to support a recommendation that road diesel fuel should be brought into the excise regime.

Gaming taxation

- 2.155 The discussion paper *Gaming Reform in New Zealand*, released by the Department of Internal Affairs,⁹³ notes that a wide range of gaming is now available in New Zealand. The growth in expenditure on new forms of gambling illustrates the popularity of these forms of entertainment. However, because the predominant regulatory model remains one of monopoly restriction (lotteries) or restrictions limiting participation to 'non-profit' operators (non-casino gaming machines), explicit taxation in the form of gaming duties and implicit regulatory taxes interact.
- 2.156 Both existing restrictions on entry into the gaming industry (by operators who would meet prudential requirements) and the imposition of gaming duty are costly to consumers of gaming services.⁹⁴ It appears to us difficult to justify singling out gamblers for regulatory taxes that are earmarked for community purposes or for gaming duties that go to general revenue. Broadly based taxation enables funds for

⁹¹ A figure of \$290 million was also postulated for greenhouse gas emissions but these are ignored since they will fall under whatever carbon tax or carbon trading arrangements are put in place as part of New Zealand's response to the Kyoto Accord.

⁹² Ministry of Transport, *Land Transport Pricing Study: Full Report, Environmental Externalities*, p xxiv.

⁹³ The Department of Internal Affairs, 2001, *Gaming Reform in New Zealand: Towards a New Legislative Framework*.

⁹⁴ We note that the racing industry is reliant on gaming funding to finance the production of the product on which punters enjoy betting. The existing regulatory framework has the side effect of providing intellectual property rights protection to the industry. Given the size of the New Zealand market, some Lotteries Commission products may well have 'natural monopoly' characteristics since fragmentation of the market might prevent consumers from obtaining some preferred products (such as regular lotteries offering large prizes).

community purposes to be raised more efficiently and to be more equitably shared across the community. There is a strong presumption that funding from general taxation would allow less costly and better directed mechanisms to be used to deliver community purposes funding.

- 2.157 It appears to the Review that in the case of non-casino gaming machines, explicit and regulatory taxation can no longer be justified as extracting excess profits created by access restrictions. Since access to this form of gaming is now so widespread, it is these taxes themselves that appear as the constraint, raising prices (that is, lowering payouts) to consumers. As previously noted, these taxes appear to raise revenue at very high cost.
- 2.158 In the case of the Lotteries Commission, we believe that the form of taxation presently used to divert a portion of its profits from charitable purposes to general revenue is clearly inefficient.
- 2.159 On the understanding that the Lotteries Commission is motivated to maximise the amount available for charitable contributions, the most efficient way for the government to divert a portion of these funds to general revenue is to tax the amount contributed directly. Relative to this benchmark, taxes that cause the Lotteries Commission to further raise prices (increase its percentage take) will simultaneously reduce charitable contributions, reduce government revenue and damage consumers. In addition, among the taxes that have these damaging effects, the form used at present (a tax on turnover) will be unambiguously more damaging to charitable contributions, government revenue and consumers than the alternative (a tax on 'win') used for other forms of gaming.⁹⁵

⁹⁵ Taxation on the basis of turnover is equivalent, in the gambling industry, to the imposition of a *specific* tax. Conversion of this tax to a revenue-equivalent (at unchanged behaviour) tax on "win" is equivalent to replacing a *specific* by an *ad valorem* tax. While the revenue-equivalent substitution of *ad valorem* for *specific* taxation would not have particular economic significance in a competitive industry, for a firm in a monopoly position this change in the form of taxation should direct its pricing behaviour in a uniformly favourable direction. We understand that the change in tax base from turnover to win was proposed for, but resisted by, the Commission (perhaps because the implied revenue neutral rate of 12.5 percent was lower than the 20 percent rate applying to most other forms of gaming).

The Tax Mix

2.160 Figures 2.1 and 2.2 show the composition of tax revenue, or the ‘tax mix,’ in 1990/1991 and 1999/2000.

Figure 2.1

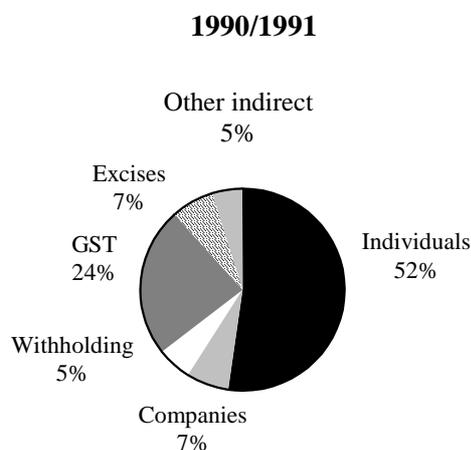
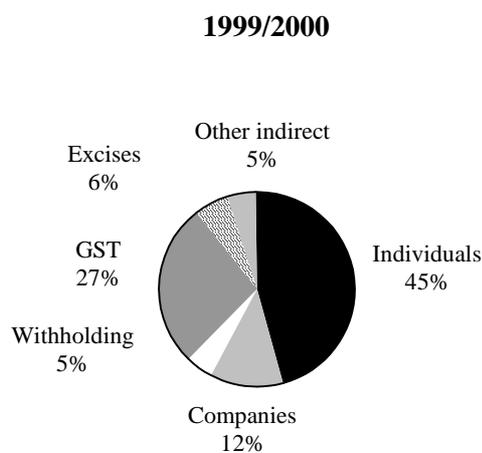


Figure 2.2



2.161 The most dramatic difference between the two figures is the relative decline in the proportion of tax collected by way of direct taxes on individuals, from 52 percent to 45 percent. This mainly reflects the effect of tax cuts in the 1990s, which were mainly delivered by way of income tax reductions. While the ratio of tax to GDP declined by 3.0 percentage points over this period, the ratio of individual income tax to GDP decreased by 3.4 percentage points.

2.162 While Figures 2.1 and 2.2 are interesting, they do not, however, provide any direct guidance in determining what the tax mix should be. In examining this issue, we have drawn on the analysis developed in Chapter One, *Frameworks*, and have reached several conclusions.

2.163 First, it is in our view desirable to spread the tax take reasonably evenly across more than one base. In particular:

- all taxes are to some extent prone to avoidance and evasion. Collecting taxes across a number of bases reduces the potential revenue cost associated with the exploitation of a new avoidance opportunity relating to a particular tax;
- the returns to avoiding or evading any one tax will be lower the less revenue is collected from that tax. Individuals will consequently be less inclined to attempt to avoid tax in the first place; and
- revenue flows from different bases normally fluctuate at varying times and to varying extents. Overall revenue flows will therefore be more stable and predictable under a system with multiple bases.

2.164 Not placing too much reliance on any one base in turn implies that tax rates should in turn not be too high. Unless applied to a narrowly defined base (which we do not recommend) high tax rates will tend to imply an over reliance on one base, creating unnecessarily strong incentives for taxpayers to seek to escape their obligations.

2.165 Of the existing bases, the GST base is relatively broader in its coverage than the income tax base. As we noted above, the GST base is very close to a theoretically pure base, but the income tax base is some way from accurately reflecting true income. This implies that there is more scope for broadening the income tax base in ways that would both raise more revenue and reduce incentives for individuals and firms to undertake investments and other activities that are less profitable when viewed from the perspective of New Zealand as a whole. The options we have suggested be considered in respect of capital gains and owner-occupied housing are relevant in this context.

2.166 The GST base is less likely to alter economic decisions than the less comprehensive income tax, and the costs to businesses of complying with GST are somewhat lower than the costs of complying with income tax.⁹⁶ It is consequently likely that the total costs imposed on the economy by the tax system would be reduced somewhat if the tax mix was altered to place relatively more reliance on GST, and relatively less on income taxes. Among other things, this implies that:

- if the government in future needs to increase taxes, we would recommend it turn first to GST; and
- when the government finds itself in a position to reduce taxes – perhaps because of additional revenue from a broader income tax – it should first look to reduce income taxes rather than GST.

⁹⁶ GST is more neutral both because the base is relatively broader and because the rate is uniform across all goods and services and is relatively low.

CHAPTER THREE

ENVIRONMENTAL EXTERNALITIES AND ECO-TAXES

In this chapter, we consider the role of a carbon tax and other eco-taxes as a part of an appropriate tax system.

We consider that an eco-tax is appropriate only when the following three conditions are broadly satisfied:

- the environmental damage of each unit of emissions is the same across the geographic area to which the tax applies;
- the volume of emissions is measurable; and
- the marginal net damage of emissions is measurable.

At a national level, we consider only greenhouse gases satisfy these conditions.

Prospects for a broader range of eco-charges may, however, be more promising at a local level. For example, each tonne of organic waste going to a landfill can be presumed to have much the same impact as any other tonne.

Advocates of eco-taxes sometimes claimed that eco-taxes deliver a ‘double dividend’, comprising the social benefits attributable to lower consumption of the good to which the eco-tax applies and the reduction in excess burdens achievable by using the eco-tax revenue to reduce other, distortionary, taxes.

We note that this second dividend can be delivered only because the eco-tax effectively expropriates property rights previously enjoyed by users of the eco-taxed good. While such expropriation cannot always be avoided, its existence should in our view be counted as a disadvantage, not an advantage, of an eco-tax.

Our view is that the appropriate burden of proof on those advocating eco-taxes should be identical to the burden placed on those seeking concessionary tax treatment for particular activities or sectors. We consider the initial presumption should always be against the introduction of selective taxes.

We note that under the Kyoto protocol New Zealand’s gross emissions in the first commitment period from 2008 are expected to exceed by about nine percent the levels required under the Kyoto Protocol. However, accounting for forests planted after 1990, which are recognised as carbon sinks under the Kyoto Protocol, New Zealand’s net emissions in 2010 will be less than 75 percent of targeted levels.

New Zealand has an unusual greenhouse gas emission profile, heavily weighted towards methane (48.5 percent) and nitrous oxide (15.9 percent) relative to carbon dioxide (35 percent). The Review has not been provided with any analysis of the impacts of methane taxes and we have been unable to find any explanation for why ruminant methane should be excluded from a New Zealand carbon tax regime. We seek further consultation on the feasibility of this form of taxation, on its efficiency in providing incentives for greenhouse gas emissions abatement in New Zealand and on the risks under Kyoto of excluding ruminant stock numbers from a carbon charge.

A carbon charge satisfies the conditions for effective eco-taxation at a national level.

We would not favour the introduction of a carbon charge prior to ratification of the Kyoto Protocol by New Zealand, because of our inability to take meaningful unilateral action to affect global climate change. Following ratification, imposition of a charge prior to the first commitment period may be desirable but only after international carbon markets begin to give clearer indications of the likely price of carbon emissions abatement.

It would be desirable for meaningful debate over the feasible, fair and efficient coverage of a national carbon charge, consistent with the government's Kyoto commitments, to begin immediately.

Introduction

- 3.1 The Review has been asked to consider the role of a carbon tax and other eco-taxes in the design of an appropriate tax system. Since taxes are only one of several approaches to addressing perceived market failures in respect of the environment, we first consider:
- the general nature of the environmental externalities that may warrant intervention; and
 - the broad implications of a variety of approaches for managing these market failures, including taxes, regulations and tradeable quotas.
- 3.2 In the context of this general framework, we then consider eco-taxes in more detail and the merits of a carbon charge in particular.

Environmental Externalities

- 3.3 As explained by the OECD, “*externalities exist because of the public goods nature of the environment. In the absence of property rights for clean air, clean water, etc. economic agents use these services without regard for the impact their decisions have on other economic agents, including future generations.*”⁹⁷

⁹⁷ Policy Environment Committee Paris, 21-23 March 2001, *Environmentally Related Taxation in OECD Countries: Issues and Strategies*, p 16. COM/ENV/EPOC/DAFFE/CFA(2000)95/REV1

- 3.4 At the local level in New Zealand, externalities do not always involve an intrinsic public goods problem. Rather they can arise when local authorities do not levy usage charges for the services they provide, such as water supply or waste disposal. The effects, however, in terms of inefficiently high and wasteful resource use and consequent environmental pressure, are much the same.

Options to address market failures

- 3.5 In this section we outline and compare three approaches to dealing with externalities: the Pigovian tax or eco-tax, tradeable quota schemes and regulatory solutions.

The Pigovian solution

- 3.6 Over 80 years ago, in the *Economics of Welfare*, the Cambridge economist Arthur Pigou proposed a theoretical solution to externality problems, under which the government levies a uniform per unit tax on emissions set equal to the ‘marginal damage’ imposed on others.⁹⁸ Marginal damage is the aggregate amount all users would be willing to pay for reduced emissions, net of cost-effective damage mitigation.
- 3.7 For a Pigovian tax to reduce emissions to a socially optimal level, three conditions must be satisfied:⁹⁹
- the *impact* of emissions should be *uniformly distributed* – in other words, the environmental damage of each unit emitted should be the same.¹⁰⁰ Greenhouse gases satisfy this criterion, since each molecule of carbon dioxide emission has the same global warming potential;
 - emissions must be measurable – otherwise, it will not be possible to effectively apply a tax. It is sometimes possible to find effective proxies. For instance, instead of measuring carbon dioxide emissions, the carbon content of various fuels might be measured and use of these products taxed according to their carbon content;¹⁰¹ and
 - the marginal net damage of emissions must also be measurable – otherwise, it will not be possible to estimate the appropriate tax rate. However, it is difficult to obtain reliable estimates in the absence of readily observable market valuations.¹⁰²

⁹⁸ Pigou, Arthur C., 1920, *The Economics of Welfare*, London, Macmillan.

⁹⁹ The socially optimal level of emissions is the level at which marginal costs incurred by emitters to implement cost-effective emissions control measures and marginal net damage are equated. Since marginal abatement costs will be equal across emitters, the total cost of achieving a given level of abatement will be minimised.

¹⁰⁰ Note that it is the damage caused by each unit taxed that needs to be uniformly distributed, *not* that each injured party must suffer the same marginal damage.

¹⁰¹ Taxation by proxy can, however, be highly inefficient when the connection between the source of damage and the taxed proxy is cheaply controlled by the emitter since no incentive is provided to undertake direct emissions control.

¹⁰² For a useful summary of techniques, see Ministry of Transport, *Land Transport Pricing Study, Full Report, Environmental Externalities*, Appendix A.

- 3.8 The first of these conditions is important in determining the level of government at which eco-taxes or charges might be contemplated. Taxation at the national level will typically be uniform across the country and will therefore only be appropriate when the assumption of uniform damage is approximately correct at the national level.
- 3.9 Cases where damage is uniformly distributed across the nation are not common. The uniform damage approximation has been found useful in the case of sulphur dioxide emissions over wide areas in the northern hemisphere. Because of their persistence, greenhouse gas emissions provide a global example where emissions from all sources are uniformly mixed and therefore have the same impact on greenhouse gas concentrations.
- 3.10 It is generally costly to measure emissions. Consequently, eco-taxes imposed at the national level would typically have to be levied on some product proxy. If input taxes (such as the fertiliser and pesticide taxes recommended in some submissions) were adopted, they would impact on environmentally beneficial as well as environmentally damaging uses. Where output taxes were selected as the proxy (for example, a tax on butterfat to mitigate surface and ground water damage caused by dairy farm run off) they would only affect emissions via their impact on production. These taxes do not provide any incentive to directly mitigate harmful environmental impacts.
- 3.11 Prospects for uniform eco-charges may be more promising at a local level. Each tonne of organic waste going to a given landfill can be presumed to have much the same impact as any other and each car on a congested road can be taken to make essentially the same contribution to the costs of delay.

Tradeable quotas

- 3.12 Tradeable quota schemes, under which the desired level of emissions is determined at the outset and the implicit level of the tax (the price for quota use) is determined through trade, are closely related to Pigovian taxation. Again, however, the uniform distribution condition is important. Catch quota schemes, for example, do not treat fish as amorphous biomass. Since it matters a lot *which* fish are caught, quota schemes are refined to apply at the appropriate level (by species and time of year, etc).
- 3.13 The greater certainty of environmental outcome that is provided by quantity controls and standards is likely to be desired whenever the costs of marginal damage vary strongly with the level of pollution, as with serious environmental hazards.

Regulatory solutions

- 3.14 It is instructive to compare the effects of an eco-tax with the effects of a regulatory approach (for example, mandated abatement measures under the Resource Management Act or under negotiated agreements):

- under mandated pollution controls, emitters are not required to pay for residual emissions. This difference is in our view critical; regulation attenuates emitters' environmental property rights at the margin but preserves their customary rights up to this point. In contrast, the eco-tax solution expropriates all emission rights to the state;¹⁰³
- abatement costs will probably not be minimised under regulation. However, minimisation of cost is only desirable when abatement is valued equally regardless of where it occurs. Whenever this is not the case, alternative, more targeted, measures are preferable; and
- emission controls that are mandated by regulation will, like those voluntarily adopted under an eco-tax, raise costs of production, in the process reducing output and further limiting emissions.

Eco-taxation and tax system design

3.15 As noted in the introduction, the Review has been asked to consider a fundamental restructuring of the tax system towards national eco-taxes. These taxes could be levied on a wide range of environmentally related inputs, including transport fuels and carbon, solid and liquid waste, fertilisers, pesticides, hazardous substances, packaging, and minerals and fisheries resource rents.

3.16 The arguments advanced in support of this programme include the following:

- society would be better off taxing bads rather than goods;
- new eco-taxes would create opportunities to recycle revenue by lowering other taxes. Since taxes typically generate excess burden (losses to the economy in excess of the revenue raised), it is argued that revenue recycling will generate a double dividend; and
- the potential for revenue recycling and double dividends is said to reduce the burden of proof on those advocating eco-taxes to demonstrate a causal link between the level of the tax and the level of environmental harm.

In which circumstances can eco-taxes be justified?

3.17 As a general proposition, the principles established in Chapter One, *Frameworks*, imply that the tax system should distort *relative prices* – the price of one good relative to the price of another – as little as possible.¹⁰⁴ Tax-related distortions to relative prices result in, among other things, producers wasting scarce resources, since they face misleading signals about the relative value of alternative inputs.

103 Because the costs of residual emissions are not factored into emitters' costs of production under the regulatory approach, output and emissions should fall less, other things being equal. If regulation imposes stricter clean-up standards than would have been voluntarily chosen under the tax, the overall level of output and emissions may, of course, end up lower under the regulatory approach.

104 In particular, as achieved in the design of the GST, it is desirable for production efficiency that all producers face the same relative prices.

3.18 Two exceptions to this general proposition can be identified:

- the first is where firms use valuable ‘unpriced’ environmental inputs. As we noted above, a legitimate case can be made for taxing ‘bads’ where their use involves ‘uninternalised’ environmental harm.¹⁰⁵ However, as we also noted above, the requirement that the damage from an environmental harm be uniformly distributed means the externality rationale for an eco-tax will be valid in only a limited number of instances; and
- the second is where the seller of an input enjoys *economic rents*. In this case, at least part of a selective tax on the input will be shifted back onto the seller (that is, the tax will not be fully absorbed into the price of the input). The portion of the tax that is borne by the seller will be in the nature of a lump sum, or non-distortionary, tax, the revenue from which can be used to reduce distortionary taxes.

3.19 Caution would need to be exercised before taking up the second of these opportunities, even where it may appear economically efficient to do so. This is because we believe there is only a limited range of circumstances where existing property rights should be appropriated, including ownership rights over assets that generate economic rents.

3.20 Among other things, the price for assets that generate rents (such as land) by their existing owners will generally reflect the capitalised value of expected future rents. Such assets may well have been acquired from the Crown. Consider, for example, the auction of spectrum rights. Suppose a resource rent tax was imposed in the aftermath of the auction but purchasers had previously been led to believe a tax would not be imposed. A level of uncertainty in relation to existing property rights would have been created.

3.21 An alternative way of taxing spectrum rights would be by selectively taxing television advertisements (as recommended in one submission). Despite the difference in label, the tax would, like the resource rent tax, reduce the value of spectrum rights. It seems clear to us that, where possible, tax policy design should observe rules that avoid encroachments on property rights whenever the direct expropriation of the right would also have been ruled out.

3.22 As a general proposition, we would expect efficiency gains from a far-reaching programme of eco-tax reform. But we believe these are more likely to arise from the cuts in taxation made possible by the expropriation of resource rents, broadly defined, than from increases in production efficiency attributable to further correction of environmental externalities.

Double dividends

3.23 We comment in this section on the argument that since eco-tax revenue can be used to reduce other, distortionary, taxes, eco-taxes will deliver a double dividend.

¹⁰⁵ For issues raised by production externalities, see W.J. Baumol and W.E. Oates, 1975, *The Theory of Environmental Policy*, Prentice Hall, Chapter 8.

- 3.24 It is in our view important to be explicit about the nature of the second dividend delivered by an eco-tax. We take it as given that the policy objective of an eco-tax is to restrict consumption of environmentally damaging goods, to the point where the marginal environmental damage of remaining consumption is equal to the marginal excess burden.
- 3.25 In principle, this objective could be achieved either by introducing an eco-tax or through regulation. Suppose regulation is used to restrict consumption of a ‘dirty’ good to the socially optimal quantity. Regulation offers no revenue for recycling. Indeed, quantity regulation will cause tax revenue to fall by shrinking the tax base of the dirty good.
- 3.26 Since other taxes will need to be raised to make up the shortfall in revenue, the resulting tax efficiency losses will act as a brake upon the gains from, and therefore the justifiable extent of, environmental correction. Pigovian taxation (or regimes under which quotas are auctioned) therefore does provide a dividend relative to the alternative of environmental regulation (or quota regimes under which quotas are grand-parented) in the presence of distorting taxes.
- 3.27 The key difference between the regulatory and taxation solutions is that:
- under the regulatory solution, emitters retain their previous environmental rights up to the limit of the quantity regulation – the only loss they suffer is the loss of their previous right to emit beyond the regulatory threshold; and
 - under the taxation solution, emitters also lose a portion of the environmental rights they previously held in respect of emissions below the regulatory threshold – while they are still able to emit, they now have to pay to do so.
- 3.28 If the policy objective is to reduce emissions to the socially optimal level, it appears to us difficult to justify the lump-sum expropriation of existing environmental use rights below this threshold. We recognise above that there are circumstances where an eco-tax will deliver an economically superior result to a regulatory solution. However, we consider the double dividend element of the eco-tax should properly be regarded as counting against the taxation approach when the relative merits of alternative approaches are being weighed up.
- 3.29 As discussed below, the extent to which customary emissions rights (including rights to carbon sinks recognised under the Kyoto Protocol) should be expropriated or preserved will pose difficult design decisions when regimes of carbon taxation or carbon quota trading are established.

The burden of proof

- 3.30 We noted above the suggestion by some that calls for national environmental tax reform should not be saddled with an "excess burden of proof". Our view is that the appropriate burden of proof on those advocating eco-taxes should be identical to the burden placed on those seeking concessionary tax treatment for particular activities or

sectors. And as we explained in Chapter One, *Frameworks*, we consider the initial presumption should always be against the introduction of selective taxes.

3.31 Our view reflects the following points:

- evidence of environmental externalities is not by itself sufficient evidence that an eco-tax would be economically desirable. Moreover, it is rarely efficient to abate emissions to the point where all environmental interactions are avoided – indeed, if it were, many (if not most) activities we take for granted would be banned. We note in this context that empirical studies may find evidence of external damage costs even under excessively stringent levels of targeted regulation;
- the argument that further reduction in a polluting activity is always beneficial is not consistent with our preferred framework, which seeks to balance competing interests. Instead, the argument to us implies a judgement that outcomes that harm the environment are demerit goods, which are always and everywhere to be further curtailed. The use of taxes to suppress, or subsidies to promote, the production of demerit or merit goods is normally seen as paternalistic since it forces the decisions of the many to conform to the opinions of a few; and
- since estimates of the damage produced by emissions are invariably highly uncertain, it is very difficult to distinguish between bona fide proposals and demerit good arguments. Extravagant estimates of external costs can sometimes become the tool of those who wish to suppress the demand for particular goods. In these circumstances, and because every activity has some external effects, the burden of proof should properly be set very high.

Carbon taxation

3.32 A carbon tax has been suggested as an instrument that could be employed by New Zealand to address the environmental harm that may be caused by global warming attributable to greenhouse gas emissions. In particular, it is argued that a carbon tax could be used to reduce the emission of carbon dioxide from the burning of fossil fuels and methane from agricultural and other sources. It is thought to be impractical to tax emissions directly, but the taxation of greenhouse gas proxies may provide a workable approach.

3.33 The science of global warming remains poorly understood. Over the last century or so the concentration of carbon dioxide in the atmosphere has increased by approximately one third above 1865 levels of approximately 280 parts per million. Carbon dioxide and other greenhouse gases absorb long wave radiation emitted by the earth, trapping heat within the earth's atmosphere. This increase in greenhouse gas concentrations should be associated with a rise in the average temperature of the globe. That increase has been difficult to detect in practice because there are many other factors that influence

temperature.¹⁰⁶ As a consequence the relationship between carbon dioxide levels and temperature remains uncertain. The International Panel on Climate Change (IPCC) currently predicts a temperature increase of between 1.4 to 5.8 degrees Celsius by 2100 (mean projection is 2.5 degrees Celsius).

- 3.34 In addition to the uncertainty about whether a significant increase in average temperature will eventuate, the effects of such an increase are extremely uncertain. The temperature effects would not be spread evenly over the globe and it is thought that the temperature effects in the Southern Hemisphere (where oceans predominate) will be less than the global average. Independently of global temperature trends, increasing carbon dioxide concentrations are predicted to stimulate plant growth (carbon uptake by photosynthesis). This should benefit New Zealand.
- 3.35 New Zealand is a party to the 1994 UN Framework Convention on Climate Change (FCCC), the primary objective of which is to “*stabilise atmospheric concentrations of greenhouse gases at a level that avoids dangerous anthropogenic (human-induced) interference with the climate system.*”
- 3.36 New Zealand has been at the forefront of attempts, under the FCCC, to negotiate a concerted international effort that would reduce greenhouse gas emissions. The result of those negotiations is the 1997 Kyoto Protocol that would commit 39 developed countries plus the European Union to take steps to constrain greenhouse gas emissions during the first commitment period (2008 to 2012). In New Zealand’s case that commitment is to constrain net emissions to 1990 levels.
- 3.37 New Zealand has indicated that it will ratify the Kyoto Protocol. If all countries meet their Kyoto targets, the result would be a five percent reduction in aggregate emissions across Kyoto countries relative to a 1990 benchmark. The IPCC has estimated that a 60 percent reduction in global emissions is necessary to stabilise atmospheric carbon dioxide concentrations. Developing countries in Asia and South America, whose emissions are growing rapidly from low bases, are not parties to the Kyoto Protocol.
- 3.38 It would appear that full compliance with Kyoto will only have a minor impact on global warming trends. Further increases in atmospheric greenhouse concentrations are unavoidable and there is no unilateral action that New Zealand can take that will make a measurable impact on greenhouse gas levels or trends since New Zealand makes an insignificant contribution (0.2 percent) to global greenhouse gas emissions.
- 3.39 New Zealand's situation differs from that of most other Kyoto signatories in three respects. First, New Zealand has an unusual greenhouse gas emissions profile, heavily weighted towards methane (48.5 percent) and nitrous oxide (15.9 percent) relative to carbon dioxide (35 percent).¹⁰⁷ Secondly, New Zealand's extensive use of clean power

¹⁰⁶ The IPCC estimate that global average air surface temperature has increased by 0.6°C (±0.2°C) since about 1860.

¹⁰⁷ These are the 1990 proportions.

sources, such as hydro-electricity generation, means that it is expected to face relatively high marginal costs in abating its CO₂ emissions in the industrial and energy sectors.¹⁰⁸ And thirdly, New Zealand has very large areas of immature plantation forests that act as sinks for carbon dioxide.

- 3.40 New Zealand's *gross* emissions are estimated to increase from 19.8 million tonnes of carbon (MtC)¹⁰⁹ per year to 21.6MtC per year between 1990 and 2010.¹¹⁰ Methane and nitrous oxide emissions are expected to fall over this period. While carbon dioxide emissions are estimated to rise significantly.¹¹¹ On a business-as-usual basis, New Zealand's *gross* emissions in the first commitment period are therefore expected to be about *nine percent in excess* of Kyoto levels.
- 3.41 Only forests planted on unforested land after 1990 are recognised as sinks under the Kyoto Protocol.¹¹² These 'Kyoto forests' are growing at a much faster rate than gross emissions and are expected to provide carbon credits of 7.1MtC per annum during the first commitment period.
- 3.42 The combined effect of these trends is that by 2010, New Zealand's *net emissions* are expected to be *less than 75 percent* of 1990 levels. If the effect of immature forests planted prior to 1990 is considered, net levels are even lower. In net terms, therefore, New Zealand's greenhouse gas record is very creditable.
- 3.43 This does not mean that New Zealand can avoid measures to constrain gross emissions. The government has given earlier indications that it would allocate sequestration rights to the owners of Kyoto forests. These rights would therefore be available for sale on international carbon markets and, once sold, would count towards other countries' greenhouse targets. Moreover, although Kyoto forest carbon credits might provide the government with the theoretical capacity to shield New Zealand consumers and businesses from the effects of Kyoto during the first commitment period, that would be contrary both to the spirit of the Protocol and to the government's announced intentions.
- 3.44 The Review understands that New Zealand's policy decisions on Kyoto include:
- achievement of New Zealand's Kyoto Protocol obligations in a manner that demonstrates environmental integrity and leadership;
 - commitment that New Zealand will not shield its emitters using carbon sink credits;

¹⁰⁸ In terms of 1990 per capita CO₂ emissions, New Zealand was ninth lowest of the 33 Annex I parties.

¹⁰⁹ These figures are expressed as the carbon content (12/44) of the "CO₂ equivalent" amount, derived by taking into account the relative global warming potential (GWP) of other greenhouse gases (methane, for example, has a GWP of 21).

¹¹⁰ See Ministry for the Environment, January 1999, *Climate Change: Domestic Policy Statement*, p 8.

¹¹¹ Business-as-usual predictions are for methane and nitrous oxide emissions to fall by eight percent and three percent respectively, while carbon dioxide emissions are estimated to rise by 39 percent over the period 1990 to 2010. See Ministry for the Environment, January 1999, *Climate Change: Domestic Policy Statement*, p 33.

¹¹² New Zealand strongly promoted the recognition of plantation forests in the Kyoto Protocol. See Ministry for the Environment, March 1998, *Climate Change: More Than Just Carbon Dioxide*, p 5.

- implementation of a practical program that keeps as low as possible the social and economic costs of achieving those obligations;
 - development of policies that establish comparable incentives to reduce emissions across different sectors; and
 - the reference date for any grand-parenting of carbon certificates to be prior to August 1995 (date the Working Group on CO₂ Policy was established).
- 3.45 Ratification would place the New Zealand government under a legally binding commitment to meet its Kyoto commitments. However, Article 17 of the Kyoto Protocol includes emissions trading among the parties as a ‘flexible mechanism’ to assist them in meeting their obligations in a cost-effective manner.
- 3.46 The Review assumes that the government will use this flexible mechanism to acquire (or dispose of) whatever carbon credits may be needed to meet New Zealand's commitments over the first commitment period.
- 3.47 We have therefore interpreted the government's commitment not to shield emitters and to provide comparable incentives across all sectors to mean that, to the extent that it is feasible and cost effective to do so, greenhouse gas emitters in New Zealand would face the international price of carbon when making decisions that will affect New Zealand's performance under the Kyoto Protocol.¹¹³ It is likely that the broad approach to which New Zealand governments have committed will have profound sectoral impacts. These sectoral and distributional effects are not adequately identified by the analytical studies carried out to date.
- 3.48 Article five of the Protocol requires New Zealand to establish a national reporting system for estimation of anthropogenic sources and sinks for all greenhouse gases. This system must be in place no later than one year prior to the first commitment period. The Review has assumed that any carbon taxes levied by New Zealand (or the definition of any carbon rights) will be aligned with the methodologies used in the national reporting system.¹¹⁴
- 3.49 To illustrate the fiscal implications of the Kyoto commitment, the Review has assumed that an international price of carbon of \$NZ50 per tonne is established as international markets develop prior to the first commitment period.¹¹⁵

¹¹³ The Review also expects that the government will keep pressure on energy efficiency through existing measures such as modifications to the building code, energy efficiency standards and consumer education.

¹¹⁴ The reporting system is subject to international review and revision, but changes will apply only to subsequent commitment periods.

¹¹⁵ This figure is consistent with the price of \$NZ13/tC CO₂ modelled for "full unrestricted Annex I trading plus key developing countries with targets and trading". See USEPA, 1998, *The Kyoto Protocol and the President's Policies to Address Climate Change: Administration Economic Analysis*, Washington. Given the assumption of developing country targets, it may be considered a low figure.

- 3.50 On the basis of this figure, New Zealand's annual allowable gross emissions (Assigned Amount Units) under Kyoto would have an international market value of \$990 million per annum. Excess annual gross emissions on business-as-usual forecasts would be valued at \$90 million per annum, while the value of Kyoto forest credits would be \$360 million per annum. It is assumed that recipients of these credits, and owners of non-Kyoto forests, will incur a contingent carbon liability that will be recognised at the time of harvest (where forests are not replanted).
- 3.51 The efficiency objective served by confronting New Zealand emitters with the international (emissions) price of carbon is to minimise the \$90 million per annum business-as-usual cost of excess gross emissions to New Zealand. To the extent that efficient abatement opportunities are available to New Zealand emitters up to the international price of carbon, net credits may become available for sale by the New Zealand government under the Emissions Trading program.
- 3.52 The Treasury has examined the application of a carbon charge to sources of CO₂.¹¹⁶ Among the options, that clearly preferred is the application of the tax at the point of importation/production to oil, gas and coal; at the point of use to limestone used in cement and steel manufacture; and at the point of production to CO₂ released during geothermal electricity production. Taxation at these points is recommended because it is not practical to monitor and tax CO₂ emissions directly. It is also likely to be reasonably efficient because there do not appear to be important 'end of pipe' opportunities to alter the relationship between emissions and the proxies selected for taxation. The tax would be rebated on exports (where no prior CO₂ emission has occurred).
- 3.53 This carbon charge would cover almost all of New Zealand's anthropogenic CO₂ emissions. Since business-as-usual forecasts are for CO₂ emissions of 9.6MtC during the commitment period, at an international price of carbon of \$50/tC, this tax would raise \$480 million per annum at unchanged behaviour.¹¹⁷
- 3.54 Agricultural greenhouse gas emissions consist of methane and nitrous oxide. Almost 99 percent of methane emissions in agriculture arise through enteric fermentation in ruminant animals (sheep, cattle, and goats). While estimates of ruminant methane are subject to uncertainty¹¹⁸ this will be resolved for taxation purposes by the methodology adopted for the national reporting system. The use of ruminant livestock as emissions proxies provides no incentive for direct methane mitigation strategies to be adopted. This is apparently not considered likely to be a serious source of inefficiency under New Zealand conditions.¹¹⁹

¹¹⁶ See The Treasury, April 1997, *The Design of a Possible Low Level Carbon Charge for New Zealand*.

¹¹⁷ This may be compared to the \$630 million per annum raised by the existing 21cents per litre general revenue charge on petrol (which corresponds to around \$300 per tonne of carbon).

¹¹⁸ Ministry for the Environment, March 1998, *Climate Change: More Than Just Carbon Dioxide*, p 13.

¹¹⁹ *Op cit*, pp 18-22.

- 3.55 The Review believes that an annual carbon charge on ruminant methane emissions, levied on holdings of standard stock units (aligned to the national reporting system) should be feasible through the national tax system. Such a charge would cover 88 percent of New Zealand's methane emissions.¹²⁰ At an international price of \$50/tC it should raise about \$440 million at unchanged behaviour.¹²¹
- 3.56 The Review has not seen any analysis of the impacts of methane taxes and we have been unable to find any explanation for why ruminant methane should be excluded from a New Zealand carbon tax regime. We seek further consultation on the feasibility of this form of taxation, on its efficiency in providing incentives for greenhouse gas emissions abatement in New Zealand and on the risks under Kyoto of excluding ruminant stock numbers from a carbon charge.
- 3.57 Nitrous oxide emissions changes are related to livestock numbers and use of nitrogenous fertilisers. However, the processes involved depend on soil type, rainfall and temperature. Even at the aggregate level these emissions are subject to great uncertainty (± 60 percent).¹²² Whether a reliable link to practicable tax bases can be found will depend on the methodology adopted by the national reporting system.
- 3.58 While arrangements for forestry remain uncertain, it is understood that carbon credits will become available (perhaps in several tranches) to owners of Kyoto forests.¹²³ The aggregate of these credits will be equal to a standard estimate of the average stock of carbon (for example, 100tC/ha of pine forest) sequestered over the economic life of the forest. Credits for this amount of carbon will need to be surrendered (by all forest owners) at the time of harvest (if not replanted). The Review believes that this system could operate side by side with a carbon tax via trading on international carbon credit markets.
- 3.59 Alternatively it would seem feasible to integrate forestry into a system of carbon taxation with the government providing tax credits, and collecting taxes, at rates reflecting the carbon tax levied on other sectors. The timing of these credits and taxes could match the timing of the accrual and surrender of carbon credits under the emissions trading system presently proposed.
- 3.60 The Climate Change Consultation Document notes the 'in principle' decision that *"during the commitment period, a domestic emissions trading program interfacing with an international emissions trading system will play a central role in New Zealand's domestic policy response. The design of the regime will aim to maximise the coverage*

¹²⁰ Methane is produced by anaerobic decomposition of organic wastes, with landfills contributing about 3.5 percent of total methane emissions. Some larger, newer landfills have methane extraction facilities.

¹²¹ At current stock numbers this carbon charge is equal to about \$4 per stock unit per annum.

¹²² Ministry for the Environment, March 1998, *Climate Change: More Than Just Carbon Dioxide*, p 16.

¹²³ We understand the proportion of credits going to owners of Kyoto forests planted in the pre-commitment period is undecided.

of gases, sources and 'Kyoto sinks.'"¹²⁴ The Document claims it to be "*an advantage of emissions trading as a central economic instrument as compared with a carbon charge that it provides certainty about the quantity of emissions reductions achieved.*"¹²⁵

- 3.61 The Review considers that, compared to the system of carbon taxation outlined above, a domestic emissions trading system is sure to involve very high costs of design, monitoring and compliance. The claimed advantage of certainty of outcome would be sustainable in the absence of international carbon credit trading opportunities. However integration to an international emissions trading system is a key feature of the proposed emissions trading system.¹²⁶
- 3.62 In the paper examining a CO₂ carbon charge, the Treasury canvasses the view that "*Existing levels of emissions should be exempted under a 'grandparenting' provision. Some emitters may have achieved some or all cost-effective reductions voluntarily before the introduction of a charge and so should be exempt from it.*"¹²⁷ Partial grandparenting has been proposed as a possibility under a domestic emissions trading regime, with the remaining emissions rights being auctioned.¹²⁸
- 3.63 The Review is unable to understand why existing emissions should be exempted under a carbon charge. Those who have already reduced their reliance on fossil fuels will automatically be rewarded by the lower carbon charges they face. In addition, the proposal would be inconsistent with any decision to allow consequences of Kyoto to impact fully on forest owners.
- 3.64 Moreover, we would warn that attempts to grand-parent allocations of emissions units or excuse tax liabilities under a carbon charge, by reference to historical (pre-August 1995) events, will be highly arbitrary, socially divisive and therefore ultimately extremely costly. As time passes, tax exemptions based on events in the period 1990-1995 will only appear more arbitrary and less sustainable.
- 3.65 In summary, it appears that a carbon charge satisfies the important conditions for effective eco-taxation at the national level. The problem is certainly a national one. Satisfactory taxable proxies appear to exist for the great bulk of emissions whose impact (marginal damage) will be clearly defined by the national reporting system established under New Zealand's Kyoto commitments. The broad coverage of the regime will ensure that abatement costs are minimised by equalising marginal costs of abatement on all important margins. The price established by international carbon credit trading prior

¹²⁴ See Ministry for the Environment, January 1999, *Climate Change: Domestic Policy Statement*, p 50.

¹²⁵ *Op cit*, p 49.

¹²⁶ Indeed, far from providing certainty, the government might reasonably consider that (international) emissions trading by "legal entities" would introduce unacceptable fiscal risks into the management of its legally binding Kyoto commitment.

¹²⁷ See The Treasury, April 1997, *The Design of a Possible Low Level Carbon Charge for New Zealand*, p 9.

¹²⁸ Ministry for the Environment, August 1998, *Technical Design Issues for a Domestic Emissions Trading Regime for Greenhouse Gases: A Working Paper*, Chapter 7.

to the first commitment period is expected to provide guidance on the level at which to set (and periodically adjust) a carbon charge. Emissions trading should provide the government with a flexible mechanism to meet New Zealand's legally binding Kyoto obligations.

3.66 Because of New Zealand's inability to take meaningful unilateral action to affect global climate change, we would not favour the introduction of a carbon charge prior to ratification by New Zealand of the Kyoto Protocol. Following that, imposition of a charge prior to the first commitment period may be desirable,¹²⁹ but only after international carbon markets begin to give clearer indications of the likely price of carbon (emissions abatement). It would be desirable for meaningful debate over the feasible, fair and efficient coverage of a national carbon charge, consistent with the government's Kyoto commitments, to begin immediately.

¹²⁹ We note that, under Kyoto, New Zealand must, in 2005, provide evidence of "demonstrable progress" in meeting its targets.

CHAPTER FOUR

TAX RATES

This chapter discusses company and personal tax rates and the relationship between them, as well as related issues with the unit of taxation and the tax implications of targeted and universal spending. In broad terms, we conclude that:

A progressive personal income tax rate scale does not redistribute income substantially more than a proportional one. Most redistribution is done through government spending.

A proportional tax scale has substantial benefits over a progressive one in terms of efficiency, administration costs, and reducing incentives to split income, but a proportional tax would result in income losses for low-income earners relative to the status quo.

A progressive tax scale requires compromises between economic efficiency and fairness goals. Our analysis suggests that a two-rate scale best balances these goals.

The individual rather than the family should be the unit of taxation in a diverse and changing society.

The high effective marginal tax rates that emerge from the interaction of the taxation and benefit system cannot be reduced without making some beneficiaries better off than working people.

The current tax/benefit regime may be more complicated than it needs to be. However, changes to the tax system will have little impact on this complexity and reform of the benefit system is beyond the scope of the Review.

Given the different roles of the company, setting its rate is a complex matter. There is no simple rule of economics that gives guidance as to the right rate. To the extent company tax is attributable to New Zealand residents, there is a strong case for aligning the company tax rate with the top marginal tax rate.

However, this approach is not necessarily appropriate if it would result in a rate that was materially out of step with international norms, particularly if foreign investors are motivated by 'headline' rates of company tax.

Personal Tax Rates

- 4.1 The personal income tax has two objectives: generating revenue for the government and reducing income inequality.¹³⁰ Lower tax rates at low incomes and higher tax rates at high incomes (progressivity) are used to increase the redistributive impact of the tax system.¹³¹
- 4.2 This raises the difficult question of how the income tax rate scale should be designed to collect the required revenue efficiently while contributing to income redistribution. In considering this question, the Review has had regard to the effectiveness of the current scale and its interaction with the welfare system, possible changes to the scale, and the economic, social and administrative effects of such changes.

The current tax scale and its history

- 4.3 Currently, the following effective personal tax rates apply:

Tax Rate	Income Threshold
15%	Income to \$9,500 ¹³²
21%	Income from \$9,501 to \$38,000
33%	Income from \$38,001 to \$60,000
39%	Income above \$60,000

- 4.4 New Zealand's tax scale has changed significantly over time. The trend until the 1990s was towards a smaller number of rates, with less variation between the rates. The flattening of the scale was accompanied by a broadening of the income tax base through reductions in the number of concessions and allowable deductions and through the introduction of the fringe benefit tax. In addition, greater use was made of withholding, with the extension of the PAYE system and the introduction of the resident withholding tax on interest payments and unimputed dividends. While the top statutory rate was halved, the amount of tax collected from high-income individuals remained roughly the same.

¹³⁰ Personal income tax generates about \$19 billion per annum, 52 percent of the total tax take. Including corporate tax income of \$4.8 billion increases this to 65 percent.

¹³¹ Progressivity means that the average tax rate rises with income: people with higher incomes pay a larger proportion of their income in taxes. Progressivity is generally implemented through marginal tax rates that rise with income. An individual's *average* tax rate is their total tax liability as a proportion of their total taxable income. Their *marginal* tax rate is the tax rate on the next dollar they earn.

¹³² This is achieved through the Low Income Earner Rebate (LIER). The LIER only applies to labour income and the investment income of recipients of New Zealand superannuation or veterans' pensions. The LIER is received at the rate of 4.5 cents per dollar on the first \$9,500 of eligible income. It is abated against total income at the rate of 1.5 cents per dollar between \$9,500 and \$38,000. The rebate is fully abated once people have a total income of \$38,000. The average tax rate up to \$38,000 is 19.5 percent. People who have only investment income (such as rents, interest, dividends or royalties) and a total income below \$38,000 only face the 19.5 percent rate.

Table 4.2 – Personal Income Tax Scale 1967 - 2001

Year	Number of Tax Rates	Rate Progression
1967	33 tax rates	Rates ranged from 15% to 60%
1977	19 tax rates	Rates ranged from 20% to 60%
1985	5 tax rates	Rates ranged from 20% to 66%
1990	3 tax rates	Rates 15%, 28% and 33%, with top rate threshold at \$30,875
1998	3 tax rates	Rates 15%, 21% and 33%, with top threshold at \$38,000
2001	4 tax rates	Rates 15%, 21%, 33% and 39%, with top threshold at \$60,000

- 4.5 Changes through the 1990s saw the middle rate fall from 28 percent to the current 21 percent, and the threshold rise from \$30,875 to \$38,000. This reduced the relevance of the 15 percent rate, which was originally designed to offer relief for taxpayers from the 28 percent rate. Once the middle rate reduced to 21 percent, the justification for relief reduced too.¹³³
- 4.6 Reducing the middle rate to 21 percent also opened up a large gap between the middle and top rates. Families with one earner in the 33 percent bracket and another on 21 percent have a strong incentive to allocate income to the lower rate partner. The large gap also reduced the accuracy of withholding systems for interest and dividends, and complicated the taxation of superannuation funds.
- 4.7 Adding the 39 percent bracket worsened these problems. Where the large difference between 33 percent and 21 percent provided a strong incentive to split income, the difference between 39 percent and 21 percent now provides an even stronger incentive. Even the difference between 39 percent and 33 percent offers a substantial reward to tax avoidance.
- 4.8 One common form of income splitting is the settling of income-earning assets on a family trust whose beneficiaries are minors. Since the parents of minor beneficiaries will likely have control over any funds received as distributions from such a trust, they can avoid the 39 percent rate by channelling their income through the trust and having it taxed at the marginal rates of their children, which are likely to be lower.

¹³³ Removing the 15 percent rate would have resulted in one rate of 19.5 percent below \$38,000, lower than the bottom rate applying during the mid-1980s. At \$38,000 the combined effect of the 15 percent and 21 percent rates is an average rate of 19.5 percent.

- 4.9 The government has moved to reduce the revenue loss from this activity by increasing the tax rate on the beneficiary income of minors to 33 percent. However, this measure does not solve the problem entirely, because with both trustee income and beneficiary income taxed at 33 percent, individuals with income over \$60,000 can still benefit from the use of trusts to avoid the 39 percent rate.
- 4.10 Other forms of income splitting have not been targeted by specific rules and would probably not be caught by the existing anti-avoidance provisions. For example, a high-income individual can transfer income-earning assets to his or her spouse by means of a matrimonial property settlement. The maximum tax saving occurs when the spouse has no other income. In 1995, for example, the maximum tax saving was \$2,779, and this would occur if \$30,875 was transferred to the spouse from an original income of \$61,750 or more. Now, with the 21 percent and 39 percent rates in place, the maximum tax saving is \$8,730, which is achieved when an income of \$120,000 or more is split into two incomes of \$60,000 or more.
- 4.11 A number of entity tax rates were aligned to the previous top personal income tax rate of 33 percent. These included the company tax rate, the fringe benefit tax rate, the specified superannuation contribution withholding tax rate, the tax rate on registered superannuation schemes, the tax rate on life insurance policyholders, the tax rate on trustee income, and the resident withholding tax rate on interest. Increasing the personal income tax rate on incomes above \$60,000 from 33 percent to 39 percent created a gap between the top personal income tax rate and these other tax rates. For example, there is now an incentive for individuals to ensure income in excess of \$60,000 is earned through a company and taxed at a flat rate of 33 percent, avoiding the 39 percent rate that would otherwise apply. The three-rate scale in place prior to the introduction of the 39 percent rate had been designed to avoid this kind of problem.
- 4.12 The government has introduced an attribution rule allowing the Commissioner of Inland Revenue to deem income earned by certain companies to be earned by their shareholders and thus potentially subject to the 39 percent rate. The rule is designed to apply to companies that serve primarily to protect their shareholders from the 39 percent rate, but only compromises a limited number of such companies and may also affect companies that were established for genuine business reasons. Thus it is not a perfect solution to the problem.
- 4.13 The Review's observation is that use of companies and trusts to shelter income in the wake of the 39 percent rate is reasonably widespread. The ability of taxpayers to avoid the 39 percent rate undermines the credibility of the tax system and increases the focus on tax planning where previously taxpayers had complied with their tax obligations.

Issues with the current personal tax scale

- 4.14 The personal tax scale raises revenue, has economic costs, and reduces income inequality. The economic costs are outlined in Chapter One, *Frameworks*: the personal income tax discourages specialisation, work, enterprise, investment in education and

training, and saving. The incidence story is the same for the personal tax too; to the extent that people can offset personal taxes through pay rises or price increases, the tax is passed on to other people.

- 4.15 Some problems are particular to the multiple tax rates that characterise personal taxes. As well as encouraging avoidance, multiple rates increase complexity and disadvantage people with uneven income flows. For example, people receiving lump sums following dispute resolution with ACC, or beneficiaries who earn non-benefit income, have their income tax withheld at 21 percent when their appropriate marginal tax rate may instead be 15 percent.

Effect of the tax scale on inequality

- 4.16 Some submissions to the Review supported reducing inequality by increasing progressivity, while others supported minimising incentive effects by reducing progressivity. We have therefore explained the effect of the current progressive tax scale on income distribution. A useful way of assessing this is to compare the extent of redistribution provided by the current scale relative to a proportional scale, by plotting the tax paid under each scale against government spending by income decile (see Figure 4.1).

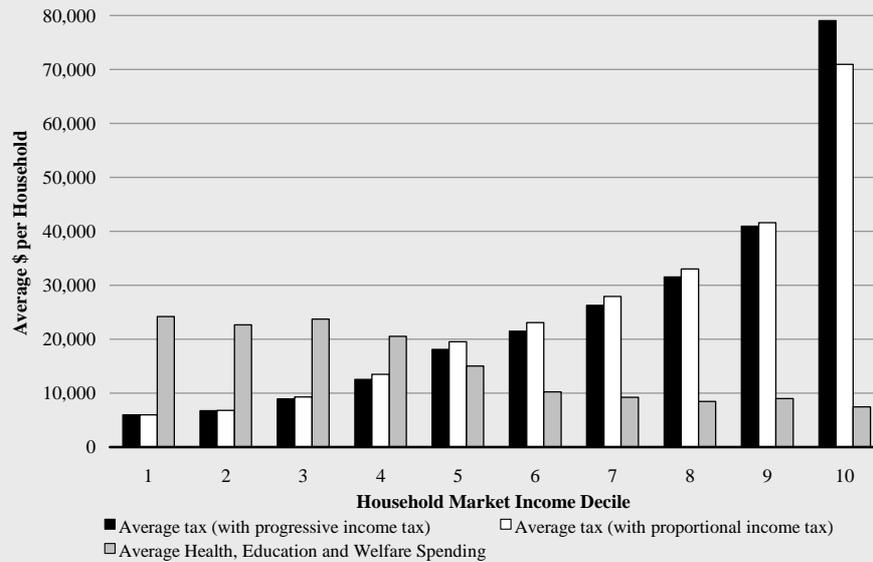
- 4.17 This analysis shows that the current progressive tax rate scale does not in fact redistribute income substantially more than a proportional one.

The Impact of Progressivity on Redistribution

The chart below shows the contribution of personal tax scale progressivity to redistribution, compared with a proportional tax that raises the same amount of revenue.¹³⁴ Allocating spending and taxes to households requires a large number of assumptions and estimates. However, the overall picture is clear.

¹³⁴ The chart shows government spending on benefits, health and education per household, and total tax per household under the current tax scale and under a proportional personal tax scale (holding other taxes constant) for each market income decile of the population (that is, taking the population of households, arranging it in order of income, and dividing it into ten equal sized groups). The fiscally neutral proportional tax rate is 25 percent, including corporate taxes. This is a static calculation; it just multiplies current incomes by 25 percent and does not allow for change in behaviour or reductions in administration costs.

Figure 4.1 – Average Health, Education and Welfare Spending and Average Tax per Household by Household Market Income Decile

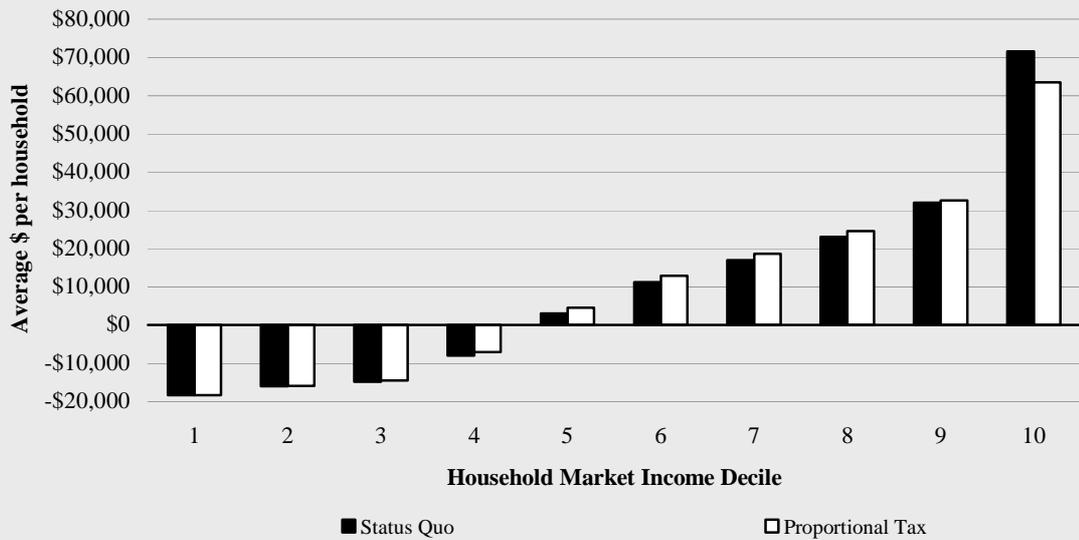


Significant income redistribution takes place. The households that have the lowest market incomes pay the least tax but receive the greatest direct benefit from government spending.

The amount of tax paid under the current progressive scale and under a proportional rate of 25 percent is roughly the same for most deciles. Under progressivity, extra tax is clearly being taken from people in the highest decile, allowing slightly lower taxation of people in deciles two through nine. Decile one is unaffected, as people here have no market income. The real engine for income redistribution is the payment of more tax as income rises, and government expenditure on benefits, education and health.

Figure 4.2 below presents the same data differently. It shows total tax less total government spending for each decile under the status quo and under a proportional personal tax scale. Columns below the zero line show households receiving more from government than they pay in tax; columns above the zero line show households paying more in tax than they receive.

Figure 4.2 – Average Tax less Average Health, Education and Welfare Spending by Household Market Income Decile



As before, tax and spending has a large impact, and the impact of progressivity above proportionality is small.

4.18 The limited redistribution effect of progressive taxation does not arise from defects in the current scale compared with other progressive scales, but rather from the inherent limitations of progressive taxation. There are several limitations, and we deal with each in turn.

Many low income taxpayers, few high income taxpayers

4.19 There are about 200,000 taxpayers earning above \$60,000 per annum, and about 1,650,000 earning below \$30,000 per annum. One dollar taken in tax off each member of the high income group provides only 12 cents to each member of the low income group.

Low rates at the bottom reduce revenue from high income taxpayers

4.20 A taxpayer whose marginal rate is 39 percent does not actually pay 39 percent of their total income in tax. Because of the progressive rate structure, an individual with \$60,000 in income pays \$14,600, or 24 percent of their income, in tax, slightly less than the person would pay at a proportional rate of 25 percent.¹³⁵ Thus the average tax rate of all taxpayers above \$9,500 is lower than their marginal rate. This means that reducing marginal rates for low-income taxpayers reduces average rates for middle and high-income taxpayers.

¹³⁵ The first \$9,500 is taxed at 15 percent; the next \$28,500 (up to a total income of \$38,000) at 21 percent; and the next \$22,000 (up to a total income of \$60,000) at 33 percent. Only income above \$60,000 is taxed at 39 percent.

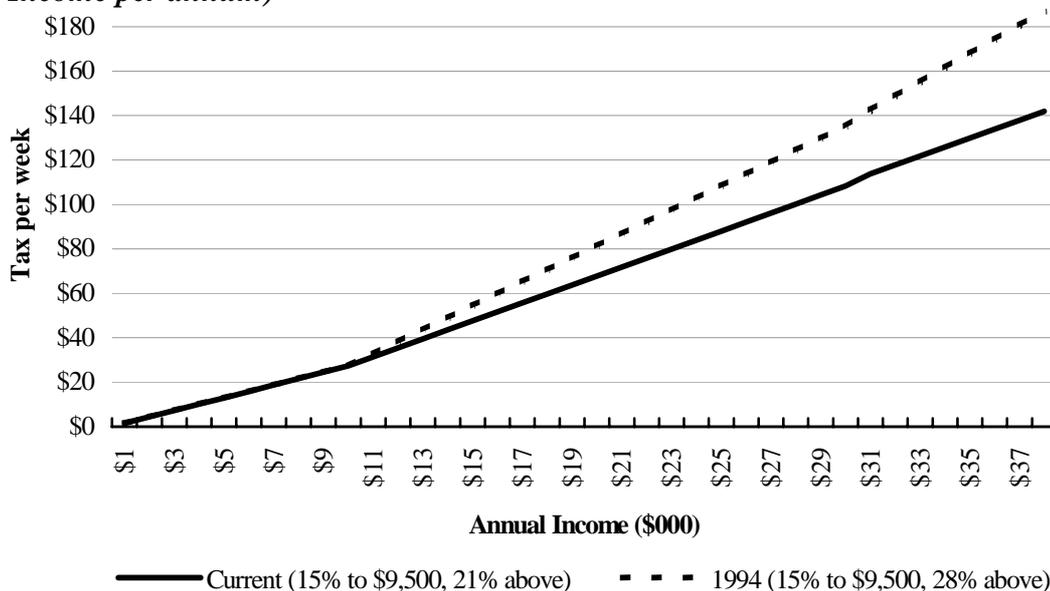
4.21 The revenue costs of reducing the marginal tax rates applying to low income taxpayers can be substantial. For example, a tax-free zone up to income of \$9,500 would raise no tax from the first \$9,500 earned by every taxpayer. A tax-free zone to \$9,500 would cost about \$2.7 billion. Of this, \$450 million would go to taxpayers earning less than \$9,500, and \$2.25 billion would go to taxpayers earning more than \$9,500, at a rate of \$1,425 each. Getting the \$2.25 billion back (that is, just giving \$450 million to taxpayers earning less than \$9,500) would require imposing higher marginal tax rates on taxpayers earning above \$9,500, resulting in higher economic costs.

Low incomes mean low tax payments; high incomes mean high tax payments

4.22 At a high level, differences in income make a bigger contribution to differences in tax liability than differences in the tax regime. This reflects basic maths: a one percentage point difference in the tax rate means \$10 per annum at an income of \$1,000 per annum, \$100 per annum at an income of \$10,000 per annum, and \$200 per annum at an income of \$20,000 per annum.

4.23 Applied to tax rates, low tax rates at the bottom of the scale provide more absolute dollar assistance to people with higher incomes within the low income group. For example, changes in the 1990s reduced the middle tax rate from 28 percent to 21 percent. This was worth about \$14 per week at an annual income of \$20,000 and about \$28 per week at \$30,000, as shown in figure 4.3 below. Consequently the higher a person’s income, the greater the benefit they received from the tax reduction.

Figure 4.3 – Comparison of the 1994 and Current Personal Tax Scales (up to \$38,000 Income per annum)



4.24 Thus change to the personal tax scale has limited capacity to assist low earners; significant changes in tax rates had modest effects on cash in hand.

Taxable income as a measure of need

- 4.25 Even if a progressive tax scale could be designed that would effectively redistribute income in favour of low-income earners, it would not necessarily address inequity because low incomes are not a perfect indicator of need. A household may have little taxable income but substantial assets (such as land, savings or investments).
- 4.26 Lower tax rates at low incomes (especially free zones) are based on the premise that low taxable income is a good indicator of need. While high income is a reasonable indicator of wealth (though that wealth or income may be temporary), low income is not a good indicator of poverty. People in poverty have low taxable incomes, but most people on low taxable incomes are not in poverty.
- 4.27 As we noted above, those with very low incomes would get the least real benefit from changes to the personal tax scale because they pay the smallest amount of tax regardless of the tax scale adopted. We note also that the redistribution that does occur through the tax rate scale applies to households with low *market* income. Benefits are adjusted for tax, so people in deciles one to three, who have little or no income other than benefit income, get little or no direct benefit from lower tax rates on their income.
- 4.28 We cannot say exactly how many people with low taxable incomes are in fact needy. We can say that many people have low taxable income; but:
- many would not directly benefit from lower tax rates (for example, beneficiaries with no market income);
 - many would get little direct benefit from lower tax rates (for example, beneficiaries with some market income);
 - many are not poor (for example, members of middle-to-high income households who have transferred income earning assets to trusts);
 - many experience low incomes for short periods (for example, students, short-term unemployed, part-year workers);
 - some have assets (for example, self-employed, superannuitants); and
 - a minority earn low taxable incomes year after year, and are poor.
- 4.29 Overall, some people with low taxable incomes are needy, but annual taxable income is not a reliable proxy for need.

Implications for tax scale design

- 4.30 Designing a personal tax scale involves making trade-offs between efficiency, simplicity and fairness. In considering tax scale design, it is important to remember that past changes to tax rates have created static winners and losers. Future tax rate changes will do this too. However, a focus on the absolute dollar change in static post-tax income as a result of tax changes overstates the effect of such changes on people's lives for three reasons:

- people's incomes and behaviour can change to offset tax changes, through factors such as seeking wage adjustments and changing jobs or job conditions;
- people are members of households, which often have more than one earner, and losses incurred by individuals may be offset by gains to other members of the household; and
- the dynamic effects in the economy and society over time, though difficult to quantify, may be more important.

4.31 From our analysis we have concluded that reducing the lower tax rates has only limited ability to help low-income earners via progressivity, whereas doing so is costly in excess burden terms. For example, increasing progressivity by introducing a free zone to \$9,500 would reduce the tax liability of someone on \$20,000 per annum by an additional \$17.31 per week, but would require the other tax rates to move to 26 percent, 39 percent and 49 percent, assuming the corporate rate is held at 33 percent to fund this change.

4.32 High marginal tax rates at the top of the income distribution discourage education and training and encourage emigration. The top income group does almost all the saving in New Zealand, and saving appears to be a residual that changes with fluctuations in income while consumption remains relatively constant. People in the top income group are likely to respond to increased tax rates by reducing saving, pushing the tax on to others by raising the prices of their services, or increasing efforts at avoidance.

4.33 The Review therefore considers that a proportional scale offers substantial benefits over a progressive one in terms of efficiency, administration costs and avoidance. However, this must be considered against the fact that a revenue-neutral proportional scale including the corporate tax rate would result in significant income losses to low-income earners. Also, many New Zealanders value the extra redistribution provided by progressivity, and this was reflected in the submissions. The desire for some element of progressivity was also reflected in the Report of the 1982 McCaw Task Force which stated that:

*If a proportional scale is unacceptable, then a scale with a modest degree of progressivity over either the lower- or higher-income range, or both, and with a long flat bracket for the majority of individuals, may offer a reasonable compromise between economic efficiency and equity goals. This is the Task Force's preferred approach.*¹³⁶

¹³⁶ Task Force on Tax Reform, April 1982, *Report of the Task Force on Tax Reform*, p 134.

Progressive tax scale design

- 4.34 The design of a progressive tax scale involves many possible combinations of rates and income thresholds, all reflecting varying judgements on the trade-offs between efficiency, simplicity and fairness. The strengths and weaknesses of the current tax scale represent a convenient, if somewhat arbitrary, starting point for our analysis.
- 4.35 A four-rate regime assumes a level of precision in the relationship between taxable income and circumstances (ability to pay, or need) that is a very crude approximation of the real world.

The bottom (15 percent to \$9,500) step

- 4.36 In terms of the bottom step, people with taxable incomes just above the current 15 percent /\$9,500 threshold are often as deserving of low marginal tax rates as people below. Many people who are working on low wages earn more than \$9,500, and so face a 21 percent marginal tax rate. The step at \$9,500 also increases complexity and leads to problems with either over withholding at secondary tax rates or tax liabilities at year-end. These problems particularly affect beneficiaries attempting to enter the workforce. Removing the lower step would resolve many of these issues but would create some static losers. The size of these losses depends on the rate that replaces the 15 percent rate; each percentage point increase would cost \$1.83 per week for a taxpayer on \$9,500.
- 4.37 Recent experience shows that additional upper steps also complicate the withholding and imputation systems, increase opportunities for avoidance, reduce fairness among taxpayers with similar incomes (as some people have a greater ability to avoid taxes than others), and increase compliance and administration costs.
- 4.38 This analysis leads the Review to favour a two-rate scale that can:
- retain progressivity while reducing the associated costs relative to the current scale; and
 - minimise static losses to low income earners, relative to a proportional tax.
- 4.39 Two-rate scales have three elements: the two rates and the location of the threshold. This creates a wide range of possibilities. For illustrative purposes the table below shows a number of roughly fiscally neutral two-rate scales, with the threshold at \$29,500 and the corporate rate aligned with the top personal rate.

Table 4.3 – Fiscally Neutral Two-Rate Tax Scales, \$29,500 Threshold

Personal low	Personal high and corporate	Static effect on income per week at \$20,000 p.a.	Static effect on income per week at \$30,000 p.a.	Static effect on income per week at \$75,000 p.a.
17%	34%	-\$4.42	-\$12.12	-\$2.31
18%	33%	-\$0.58	-\$6.63	-\$5.48
19%	32%	\$3.27	-\$1.15	-\$8.65
20%	31%	\$7.12	\$4.33	-\$11.83

4.40 Changes to the taxation of capital gains and owner-occupied housing, examined in Chapter Two, have the potential to increase tax revenue. For instance, we estimate that if housing were to be taxed using the RFRM an additional \$750 million in revenue would be generated. If this revenue was used to reduce personal income tax rates, then two-rate scales with lower tax rates could be achieved. Some examples are shown below.

Table 4.4 – Two-Rate Scales; Fiscal Cost \$650-\$950 million; \$29,500 Threshold

Personal low	Personal high and corporate	Static effect on income per week at \$20,000 p.a.	Static effect on income per week at \$30,000 p.a.	Static effect on income per week at \$75,000 p.a.
16%	33%	-\$8.27	-\$17.79	-\$16.63
17%	32%	-\$4.42	-\$12.31	-\$19.81
18%	31%	-\$0.58	-\$6.83	-\$22.98
19%	30%	\$3.27	-\$1.35	-\$26.15
20%	28%	\$7.12	\$4.04	-\$38.08

Conclusions

4.41 A proportional scale provides important benefits and would support the level of redistribution sought by governments. Also, the limitations and costs of tax progressivity mean that increases in redistribution are best done through spending, rather than by increasing the progressivity of the personal tax scale.

4.42 However, the Review recognises that the extra redistribution provided by progressivity is also valued. We therefore support a two-rate tax scale rather than a single rate at this stage.

Taxable Unit

- 4.43 Tax can be assessed on either household income or individual income. Currently the personal tax scale is based on individual income while Family Assistance Tax Credits and the benefit system are based on household income. The above discussion of tax rates assumed an individual basis for taxation.
- 4.44 The attraction of a household basis for taxation is that household income gives a better indication of a person's circumstances than individual income. As noted above, many people with low taxable incomes are members of middle or high- income households. The closer connection between household income and circumstances is the reason the benefit system is based on household income.
- 4.45 However, modern households are complex and changeable. A tax system that tried to follow these complexities and changes would be even more complicated and costly.
- 4.46 A number of submissions to the Review raised the more limited issue of allowing couples to divide their total income evenly between each person in the couple (income splitting). This allows both individuals to access the lower tax rates at the bottom of the tax scale twice. This makes no difference to a couple who are both working and have similar incomes, but it reduces the tax burden on single-income two-parent families.
- 4.47 Progressive taxes inevitably create anomalies either between households with the same income or between individuals with the same income. The more progressive the personal tax scale, the larger the anomalies.
- 4.48 Under the current tax scale, a household with two \$25,000 incomes pays \$9,360 in tax (with a marginal rate on both incomes of 21 percent). A household with one \$50,000 income and a non-earning partner pays \$11,370.¹³⁷
- 4.49 If the single income household were allowed to split its income between the two partners as if each earned \$25,000, it too would benefit twice from low tax rates at the bottom of the tax scale and avoid the 33 percent rate. This would have two effects, which may be considered undesirable:
- the individual earning \$50,000 pays \$2,010 less tax than another individual with the same income, but without a non-working partner; and
 - the marginal tax rate of the non-earning partner rises from 15 percent to 21 percent (the marginal rate of the earning partner falls to 21 percent). The marginal rates change because each partner is now taxed as if they had an income of \$25,000. The increase in the marginal rate reduces the incentives of the non-earning partner to enter the labour market.

¹³⁷ This is because the two-income household benefits twice from the 15 percent tax rate to \$9,500 and neither of its single incomes are high enough to reach the 33 percent tax bracket. The one-income household gets the 15 percent to \$9,500 once, and \$12,000 of its \$50,000 income is taxed at 33 percent.

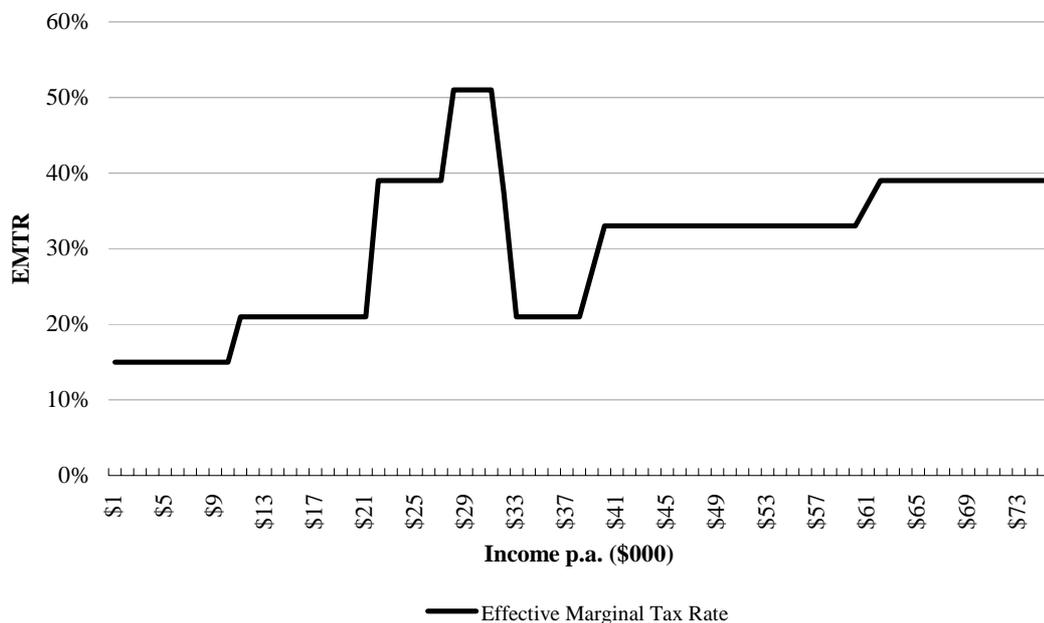
- 4.50 While the two households have similar incomes, the double income household may have higher expenses in terms of travel and childcare. The single income household will also have the benefit of the unpaid work of the non-earning partner.
- 4.51 Income splitting creates as many problems as it solves. Also, it is not well targeted. Income splitting favours any couple with one income. Traditional families with an ‘empty nest’ and a well-paid principal earner would benefit; working sole parents with dependent children would not.
- 4.52 The Review considers individual-based taxation is the best approach in a diverse, changing society. Concerns with household characteristics (for example, children) are best addressed through government spending. This is because, as well as creating as many anomalies as it resolves, household taxation is not well targeted.

Taxation and the Benefit System

- 4.53 In New Zealand, the Family Assistance Tax Credits and welfare benefits are delivered in the form of targeted assistance, usually based on income. The consequence of this is that as individuals and families move from benefits to work, their benefit is abated to reflect increasing incomes. A consequence of this is to generate effective marginal tax rates (EMTRs) higher than the statutory tax rate. An EMTR shows the percentage of an additional dollar of income that is ‘lost’ in tax and the abatement of income-tested benefits. For example, a person with a marginal tax rate of 21 percent facing 25 percent abatement of the Accommodation Supplement and the 1.3 percent ACC levy, loses 47.3 cents on an additional dollar of income. Such a person has a 47.3 percent EMTR. In extreme cases the interaction of the benefit system, tax credits and tax rates can create EMTRs of over 100 percent.
- 4.54 Under current policy we have:
- a progressive personal tax scale (as set out above) with corporate tax at 33 percent, alongside an ACC levy of 1.3 percent, GST, and excises;
 - a targeted welfare system, with basic benefits at different rates (for example, Domestic Purposes Benefit), targeted in different ways (for example, employment status, presence of dependants). Most benefits abate as market income rises. Supplementary benefits (for example, Accommodation Supplement) are available to both beneficiaries and working people. There are also two types of Family Assistance Tax Credit: Family Support, which is available to low income families with children; and Family Plus (the Family, Child and Parental Credits) which is available to low income working families with children. These are targeted on circumstances and income; and
 - universal entitlements to government services (for example, general government and health and education). Some of these are partially targeted (for example, Community Services Card and elements of tertiary education).

- 4.55 These combine to give us different EMTRs for different people. High marginal rates are problematic because they distort people’s decisions. Many submissions raised the difficulties caused by high EMTRs for those transitioning from benefits to work, or working part-time while on a benefit.
- 4.56 However, the apparent impact of high EMTRs can be exaggerated by focusing only on the EMTR on the next dollar earned. The reality is that most decisions people make imply bigger step changes than a single dollar; for example, a new job. This reality affects the real effect of EMTRs, as shown below.
- 4.57 Figure 4.4 below shows the EMTR schedule of current tax rates and Family Support for one child.¹³⁸
- 4.58 The EMTR ‘tower’ between \$20,000 and \$32,000 shows the effect of Family Support abatement. Any change in the recipient’s income *within* this range is fully affected by the tax plus Family Support EMTR of between 39 percent and 51 percent. However, changes in income that fall even partly *outside* the range are only partially affected.
- 4.59 Further, once past the tower, the EMTR falls again. Since increases in income over time are common, even increases within the tower range are worthwhile as part of a progression of income increases over time.

Figure 4.4 – EMTRs from Personal Income Tax and One Child Family Support



- 4.60 All taxpayers face EMTRs from tax rates. Of the 2.5 million taxpayers, about 250,000 taxpayers face EMTRs in excess of 50 percent. Thus high EMTRs from abatement over short income ranges may be less harmful than EMTRs from tax rates.

¹³⁸ This is a simplified EMTR profile. This profile only shows the interaction of the personal tax scale and the abatement of Family Support.

4.61 In addressing the issue of high EMTRs we must take into account the often conflicting requirements of income adequacy, fairness, incentives and fiscal cost. Efforts to achieve balance often result in complexity, which can defeat these requirements.

Targeting vs universality

4.62 Although targeting and universality refer to spending rather than taxation, the choice between them affects effective marginal tax rates:

- targeted benefits have lower fiscal costs, and can be funded with lower tax. However, the abatement of targeted payments results in higher EMTRs for recipients;
- universal payments have higher fiscal cost, requiring higher tax rates to fund the payments. However, they result in lower EMTRs for recipients because the untargted payments are not abated; and
- in moving between targeting and universality, large numbers of taxpayers are affected by small changes in tax rates, and small numbers of taxpayers are affected by large changes in EMTRs. Thus moving between universal and targeted payments affects both the levels of EMTRs and the number of individuals to whom they apply. Both have limits. The following discussion sets out some examples, and further explores the constraints.

Targeting

4.63 The table below highlights the problems that would arise if abatement rates were to be eased. The final incomes of the families are similar, in spite of the working family working 40 hours and the other families 16 hours. Any easing in the abatement would make those who both receive a benefit and work part time better off than those working full time. There is no easy answer to the difficult trade-off between ensuring those who work are not worse off than those on a benefit and the need to ensure that EMTRs from abating benefits do not act as a disincentive to work.

Table 4.5 - The Impact of Abatement

Family (Auckland, 1 child, rent \$125)	Gross earnings @\$9.56 per hour	Gross benefit \$	Net earnings (after tax & ACC) \$	Net benefit after abatement \$	AS ¹³⁹ \$	FS & CTC ¹⁴⁰ \$	Total Net Income \$
DPB + 16 hours work	152.96	238.63	119.15	199.48	21.00	45.74	385.37
Couple (Community Wage) + 16 hours	152.96	261.94	122.26	222.65	12.00	41.55	398.46

139 Accommodation Supplement

140 Family Support, Child Tax Credit

work							
Couple (working) 40 hours work	382.40	–	308.85	–	25.00	62.00	395.85

Increasing targeting

- 4.64 Some submissions suggested increased targeting of spending to reduce ‘churn’. Churn is when people pay taxes and then get goods or services from the government they could just as well have bought for themselves. The universal child benefit discussed below is a good example of churn.
- 4.65 As we have seen, targeting reduces churn, lowering spending and thus the overall tax burden and associated marginal tax rates, and makes the tax/benefit system more redistributive.
- 4.66 However, increasing targeting would increase the number of people facing high EMTRs, and there are non-tax reasons for universal provision of some government spending items.

Universal basic income

- 4.67 One response to high EMTRs is introducing a universal basic income. A number of submissions recommended this approach to the Review. A universal basic income provides every individual with an unabated annual payment from the government. Qualification would be based on age and citizenship.
- 4.68 The attraction of this idea is that it is much simpler to administer than the benefit system and it avoids the high EMTRs caused by abatement. However, this proposal also requires making difficult trade-offs between fiscal cost, income adequacy and incentives. For example, the average beneficiary receives about \$10,000 a year. A universal basic income at this level would give a family of four with two children of qualifying age \$40,000 per year without working. Any work would be taxed at 41 percent, the average static tax rate necessary to collect the \$10,000 per person.
- 4.69 The level of the payment and the tax rate needed to fund it means that in reality the government would probably not collect enough taxes to make the regime work: with \$40,000 in their pockets, the family may not do enough work at a tax rate of 41 percent to generate the tax revenue necessary to pay the \$40,000.
- 4.70 Also, the average benefit of \$10,000 a year implies that some benefits would be significantly reduced. Setting the universal basic income at \$17,000 (about the highest benefit rate) so no beneficiary was made worse off would require raising the tax rate to 67.5 percent.
- 4.71 While the universal income proposal has the benefit of removing high EMTRs and simplicity to recommend it, it appears that a universal basic income high enough to

address issues of income adequacy and thus allow removal of the benefit system would require prohibitively high tax rates to fund it.

Child benefit

- 4.72 A universal child benefit targeted on children, but not on income, is sometimes proposed.
- 4.73 The government currently targets expenditure on children in low-income families through the Family Assistance regime, mainly by way of Family Support. The introduction of a universal child benefit at \$45 per child (similar to the Family Support rates) for the 874,250 children under 15 would cost about \$1.1 billion in addition to the \$950 million currently spent on Family Support. Almost all the benefit would go to middle and upper income families since low-income families already get current Family Support and would not benefit from universality.
- 4.74 EMTRs from the tax system would rise from increases in taxes to raise the \$1.1 billion. Increasing a proportional personal tax (including corporate taxes) by one percentage point raises about \$800m. Much of the \$1.1 billion would be raised from the same families who received the universal child benefit, thereby producing churn.
- 4.75 The costs of universality often outweigh the benefits. In the child benefit example, 230,000 households benefit from lower EMTRs, at a cost of \$1.1 billion. Universality also generally has little impact on the underlying objective of the policy; paying child benefits to middle- and upper-income families does not make a major contribution to reducing child poverty.

Conclusion

- 4.76 A range of possible responses to high EMTRs have been proposed to the Review in submissions, but they all compromise other objectives. For example:
- as shown in the universal basic income and child benefit examples above, foregoing abatement greatly increases fiscal cost (and thus either EMTRs somewhere else have to increase or assistance has to become less generous);
 - lowering the abatement rate of Family Support means more families receive assistance, at higher incomes. This lowers the EMTRs of current recipients, but incurs fiscal cost to give assistance to people wealthier than current recipients and raises these new recipients' EMTRs (as they now receive an abated benefit);
 - lower tax rates would have little effect on reducing EMTRs (the maximum plausible reduction would be about four percentage points, from reducing the 21 percent rate to 17 percent; shifting the threshold of the 15 percent rate to \$12,500 would give the working couple in the example above an additional \$3.46 per week); and
 - lower assistance levels reduce fiscal cost, ease abatement, and improve incentives. However, they compromise income adequacy objectives. Reducing abatement of

main benefits or increasing the free zone would make some beneficiaries better off than working people.

- 4.77 EMTRs from abatement of social assistance are an intractable problem. They cannot be reduced without making some beneficiaries better off than working people, or incurring large costs from churn.
- 4.78 However, the current regime may be more complicated than it needs to be, with a large number of different benefits, with different rates and eligibility and abatement rules. Reducing complexity is not easy. Benefit reform is beyond the scope of this Review.
- 4.79 The best contribution changes to the personal tax scale can make to improving the situation is through simplification. This can be achieved by replacing the current 15 percent and 21 percent tax brackets with a single bracket at a rate between 17 percent and 22 percent. This will simplify withholding, and depending on the rate chosen could provide a small reduction in marginal tax rates for most beneficiaries and low-income earners. However, the gains need to be considered in the context of losses arising from the removal of the 15 percent bracket, which creates a maximum static loss of between \$3.65 (at 17 percent) and \$12.80 (at 22 percent) per week for individuals with taxable earnings of \$9,500.

Corporate Tax Rate

- 4.80 This section reviews the roles of the company tax, how these roles impact on decisions to change the company rate, and the implications of the company tax rate for New Zealand's competitiveness.

Role of the company tax

- 4.81 Company tax has two primary roles:
- for domestic shareholders, it acts as a withholding tax on company income (just like PAYE on wage and salary income). This role is reflected in the full imputation regime, which attributes company tax to resident shareholders. Company tax also acts as a backstop to the taxation of labour income, by limiting the gains made by sheltering income from personal tax in companies; and
 - for non-resident shareholders, it acts as a final tax on company income as the income accrues. Non-resident withholding taxes also apply to this income but only on distribution.

Effective tax rates

- 4.82 Debate on the appropriate company tax rate often focuses on the impact of the company tax rate on accounting profits. However, this type of measure is generally misleading as

an indicator of the tax system's impact on companies' income. There are two reasons for this:

- as noted in Chapter Two, *Tax Bases*, there is often a divergence between income as measure for tax purposes and a fully comprehensive definition of income; and
- the complex interactions between the tax system and the cost of capital to New Zealand firms, which are discussed in Chapter Six, *International Tax: Taxing Income from Inbound and Offshore Investment*, mean that the company tax rate by itself gives very little guidance about the tax system's overall impact on company profitability relative to a scenario where company income was simply exempt from tax.

4.83 The following example illustrates these points:

Example 4.1

Foreign banks are willing to lend to New Zealand firms at a net (after-tax) interest rate of 10 percent. ABC Co is considering an investment opportunity involving an outlay of \$100 that will result in the creation of an asset that can be sold two years later. The investment will be funded entirely with borrowed money on which accrued interest will be payable when the asset is sold.

We examine the amount ABC Co will require on sale of the asset *to just break even* under three different tax systems.¹⁴¹ To keep the example focused on the key messages, we abstract from some real-world details.

Part A

Company income is not taxed. ABC Co borrows \$100. At the 10 percent rate of return required by lenders, the debt obligation compounds to \$121 by the time the asset is sold. Clearly, the minimum amount ABC Co requires on sale is also \$121, implying the minimum return required by ABC Co in the absence of tax is 10 percent.

Part B

Company income is now taxable. ABC Co is required to pay tax on income defined comprehensively as net cash flows + the change in value of assets – change in value of liabilities.

Interest is tax deductible and interest paid to non-resident lenders is subject to withholding at the company tax rate of 30 percent. The lender therefore imposes an interest rate of 14.3 percent so that they will still receive 10 percent after tax.

Now, ABC Co's debt liability will grow to $\$100 \times 1.143^2 = \130.60

The minimum amount ABC Co needs to sell the asset for is \$130.60 plus net tax.

¹⁴¹ In reality, ABC Co will be looking to do better than break even. However, this assumption does not affect the conclusions and keeps the example from getting unnecessarily complicated.

Suppose the asset is sold for \$130.60. Since the implied rate of return to the asset is identical to the interest rate, the change in value of ABC Co's asset and liability will be exactly offsetting in both years 1 and 2, so no net tax will be payable in respect of changes in asset values. Similarly, since ABC's cash inflows and outflows are identical in both year one (\$100 borrowing proceeds in, \$100 investment cost out) and year two (\$130.60 sale proceeds in, \$130.60 debt repayment out), no net tax will be payable on cash flows.

If we measure the *effective tax rate* as the percentage difference between the minimum required rate of return in the presence of taxes and the minimum required rate of return in the absence of tax, or $(14.3 - 10.0)/14.3 = 30$ percent.

Part C

ABC Co is still required to pay tax on income defined comprehensively as net cash flows + the change in value of assets – change in value of liabilities.

Now, however, interest paid to non-resident lenders is not subject to withholding tax. The lender therefore imposes an interest rate of just 10 percent.

As in Part A, ABC Co's debt liability will grow to \$121.

And because ABC Co just breaks even, cash inflows will again equal cash outflows in each period, and the annual change in the value of the asset will equal the annual change in the value of the liability, meaning no net tax will be payable.

So ABC Co's effective tax rate will be $(10.0 - 10.0)/10.0 = 0$ percent.

Part D

Now, ABC Co is able to deduct \$50 of the asset's cost in year one and interest paid to non-resident lenders is now subject to a 10 percent withholding tax. So the 'grossed up' interest rate is 11.1 percent, implying the debt liability will grow to $\$100 \times 1.111^2 = \123.46 in year two.

ABC Co receives a tax refund at the end of year one of 30 percent \times \$50 = \$15, which it invests in the bank for one year for an after-tax return of $\$15 \times 11.1$ percent \times 0.7 = \$1.17.

This aside, there are no other net tax implications.

- 4.84 So the break-even sale price is $\$123.46 - \$1.17 = \$122.29$. The implied rate of return is 10.58 percent and the effective tax rate is $(10.58 - 10.0)/10.58 = 5.5$ percent.
- 4.85 We emphasise that the method used in the example to calculate effective tax rates provides a measure of the impact of the tax system on returns to investment by New Zealand firms – it does not measure the tax system's effect on returns to New Zealander's savings. We return to this matter in Chapter Seven, *Savings*.
- 4.86 Table 4.6 compares effective tax rates on investment in New Zealand with effective tax rates in other countries.

Table 4.6 – Effective Tax Rates for Investment¹⁴²

Tax System	Plant	Buildings	Land	Inventory	R&D	Mining
New Zealand	17.0	17.8	10.7	21.7	-15.9	-181.9
Australia	17.8	24.3	22.5	29.6	-128.3	7.0
Ireland- manufacturing	12.1	12.6	14.9	15.2	0.5	-9.3
Ireland- other	41.0	42.5	46.5	47.0	2.2	8.9
Japan	67.3	65.0	68.2	66.7	NA	58.8
Germany	19.5	18.4	25.6	24.3	3.1	9.9
Singapore	0.9	13.3	21.0	21.7	-25.6	-6.4
Taiwan	17.1	18.7	21.4	18.5	NA	8.6
United Kingdom	23.3	22.7	29.5	30.2	-25.6	13.5
United States	44.6	47.7	51.4	49.6	24.6	-16.6

4.87 While the calculations underpinning Table 4.6 cannot capture all the detail of each country's tax system, the table can reasonably be interpreted as providing evidence that New Zealand's tax system has less impact on both the level and pattern of investment than most other countries.

4.88 While the available evidence suggests marginal effective tax rates in New Zealand are broadly consistent across most types of business asset, there are some exceptions. The most significant area highlighted in Table 4.6 is mineral mining.

Changing the company tax rate

Impact on domestic shareholders

4.89 To the extent company earnings are attributable to domestic shareholders, the primary focus should be on aligning the company tax rate with the top personal rate. This is the only approach that is consistent with the two key roles of the company tax in this case – as a withholding tax and as a backstop to the income tax on labour income.

4.90 We have noted elsewhere (for example, in the *Entities* and *Tax Bases* chapters) that not aligning the tax rates applying to income earned directly by individuals and income earned via different types of entity creates strong incentives (and, invariably, opportunities) for individuals to avoid tax by sheltering income in entities that are subject to lower rates.

¹⁴² The assumptions used in these calculations are set out in Arthur Andersen, *An International Perspective*, p 161. The data is based on tax regimes in 1998.

4.91 Most other countries have top personal rates that are significantly above the company rate. To some, this will appear to constitute sufficient justification for New Zealand continuing to also take this approach – after all, if other countries can maintain this boundary, why can't we? In our view, the following points are relevant:

- many countries take a relatively benign view of individuals avoiding higher personal tax rates by sheltering income in entities. We do not advocate this approach, which is both inequitable and would tend to bring the tax system into disrepute;
- other countries attempt to shore up the boundary between individuals with measures such as excess retention taxes and capital gains taxes. New Zealand's past experience with an excess retention tax was that it was both relatively ineffective and distorted companies' financing decisions. We also do not recommend this approach; and
- some countries have effectively given up taking a conventional approach to enforcing the boundary and have introduced 'split rate' systems, which apply lower tax rates to income from capital than income from labour. Our preference, however, for reasons of both equity and efficiency, is that all income derived by a particular taxpayer should, where practicable, be taxed at the same rate.

4.92 Our view, therefore, is that to the extent the company tax rate impacts on New Zealand residents, the primary consideration in setting the rate should be the relationship between the company tax rate and the top marginal tax rate. As we note below, however, other factors also need to be taken into account in selecting an appropriate rate.

Impact on foreign investment

4.93 We explain in Chapter Six, *International Tax: Taxing Income from Inbound and Offshore Investment*, the economic significance of effective tax rates imposed on non-resident investors. Along with other factors, the company tax rate affects the attractiveness of New Zealand as a destination for foreign investment relative to other potential destinations.

4.94 As we explain in Chapter Six, *International Tax: Taxing Income from Inbound and Offshore Investment*, while there are a number of options available for reducing effective tax rates on foreign investment, we see advantages in reducing the statutory tax rate. Because there is potentially a significant difference between the theoretically appropriate company tax rate for domestic investors and the appropriate rate for non-residents, we propose in Chapter Six exploring the feasibility of introducing a split rate system, with a lower company tax rate applying to the extent a company's income is attributable to non-resident shareholders. Readers are referred to Chapter Six for further details.

Impact on Competitiveness

4.95 Many submissions to the Review raised the importance of international competitiveness, suggesting in this context that New Zealand's company tax rate should be no higher than those of our key trading partners.

4.96 International competitiveness can be defined in a number of ways. We have focussed on two interpretations:

- under one interpretation, an internationally competitive tax system is a system that does not unintentionally impede New Zealand's ability to attract and retain foreign investment; and
- under the other, an internationally competitive tax system is one that does not (unintentionally) impede New Zealand firms' ability to compete internationally against firms from other countries.

4.97 The discussion above on effective tax rates and in Chapter Six, *International Tax: Taxing Income from Inbound and Offshore Investment*, on the international tax system emphasises that a tax system's impact on both firms' ability to compete internationally and countries' ability to attract foreign investment depends on many factors other than just the company tax rate.

4.98 In the context of New Zealand's ability to attract foreign capital, we believe the company tax rate should not be out of line with international norms. This is for two reasons:

- while other factors also affect the effective tax rate on foreign investment, the statutory tax rate is a highly visible 'headline' indicator of the country's receptiveness to international capital flows – sometimes, perceptions matter; and
- too high a rate creates an incentive for taxpayers to seek to take deductions in New Zealand, where they would be worth more, but to return income in jurisdictions with lower rates.

4.99 We do not believe the company tax rate *per se* is a determinant of New Zealand firms' ability to compete in international markets with firms from other countries. As we noted above, effective tax rates are a more appropriate measure of the costs imposed by the tax system. And even here, we believe it is incorrect to argue that firms from countries that impose higher effective tax rates are disadvantaged in international markets. The following example reflects our reasoning.

Example 4.2

Two firms, XCo and YCo, compete in the market for tax textbooks. They face company tax rates of 0 percent and 33 percent respectively, but otherwise have identical cost structures.¹⁴³ At first sight, it appears obvious that XCo could take advantage of its lower costs to undercut YCo in the textbook market.

This conclusion is misleading. Suppose that for both firms the best alternative to being in business is to cash-up and invest the proceeds in the bank at 10 percent. Since XCo doesn't pay tax, the cashing up option will be superior if its rate of return on its textbook business falls below 10 percent. But YCo only needs to earn in excess of 6.7 percent after tax to prefer to stay in the textbook business.

It follows that if competition is such that both firms are only earning a normal before-tax return of 10 percent, XCo cannot profitably undercut YCo.

Conclusions

- 4.100 Given the different roles the company tax plays, setting its rate is a complex matter. There is no simple rule of economics that gives guidance as to the right rate. To the extent that company tax is attributable to New Zealand residents, there is a strong case for aligning the company tax rate with the top marginal tax rate.
- 4.101 However, this approach is not necessarily appropriate if it would result in a rate that was materially out of step with international norms, particularly if foreign investors are motivated by 'headline' rates of company tax.

¹⁴³ For the purposes of this example one can assume that firm X and firm Y are in different countries, but this example equally applies to the situation where firm X is a charity and thus tax exempt. This example draws on a similar discussion in the Charities Discussion Document released by the government on 14 June 2001.

CHAPTER FIVE

TAXABLE ENTITIES AND THEIR TAX TREATMENTS

In this chapter, we review the taxation of entities. In broad terms, our preliminary views are that:

Tax rules should not determine people's choices of business organisation or form.

The rate at which entities are taxed should be aligned with the marginal tax rate of their owners.

The number of existing entity-specific tax regimes should be reduced and the regimes simplified.

As far as possible, all entities should be categorised as either widely held or closely held and be subject to relative standard treatments applying to each.

The default tax treatment for widely-held entities should be the corporate treatment (including approximations of that treatment).

The default tax treatment for closely-held entities should be the partnership treatment (including approximations of that treatment).

These reforms are potentially quite radical and far-reaching. We also recognise that they are likely to involve significant transitional provisions. We would welcome submissions on the implications of these proposals, both broadly and in relation to specific entities.

Introduction

5.1 This chapter essentially focuses on income tax. People undertake much of their commercial and social activity through institutions that can be referred to as *entities*. There are two types of legal persons in most (if not all) legal systems: namely, natural persons (individuals) and statutory persons (principally, companies). These legal persons are able to enter into commercial and legal relationships, and create three further kinds of entity (which are, technically, not legal persons *per se*):

- trusts;
- partnerships; and
- associations (including joint ventures).

- 5.2 We are unaware of any taxing country that does not apply separate tax rules to some entities. The general reasons for taxing entities separately are that:
- leaving the tax base of an entity untaxed would encourage people to establish tax-preferred entities and divert taxable income to them; and
 - entities are beneficially owned by people and are therefore, in substance, agents for people. It is therefore both fair and efficient that entities be taxed as agents of their beneficial owners.
- 5.3 In this chapter, we canvass key objectives in designing rules for taxing entities. We note the key features of existing rules and the issues that arise. We conclude by discussing options for improving the existing rules.

What are the Goals in Taxing Entities and What Policy-Design Principles do they Imply?

- 5.4 Differences in the tax treatment of specific types of entity create incentives for taxpayers to shop among regimes. This results in costs of:
- conducting business in an organisational form that differs from the form that would have been chosen in the absence of tax differences;
 - searching for, designing and complying with tax effective entity regimes and structures; and
 - lobbying to procure the favourable features of other regimes on the basis of consistency and fairness.
- 5.5 The primary goal of tax policy is to minimise these costs. These costs are sensitive to the number of different entity regimes, their complexity and their substitutability. These considerations support the following principles for the taxation of entities:
- minimise the number of different general entity treatments. Where specific rules are necessary to deal with some special characteristic, they should be attached to a general treatment rather than cause a separate holistic treatment of the particular entity;
 - the boundaries between different entity-specific regimes should be drawn so that business forms falling on either side of a boundary are not closely substitutable;
 - equity or debt instruments that are issued by an entity and that are substitutable for each other should have a uniform tax treatment; and
 - the tax rate applying to an entity should be aligned with the highest personal marginal tax rate, where possible.

The Existing Entity-Specific Rules

5.6 At present, three generic tax regimes underpin most entity-specific tax regimes: namely, the company, trust and partnership regimes. The material distinguishing characteristics of these regimes are summarised in Table 5.1. These are described by reference to generic features of the relationship between individuals and the entities through which they invest – how contributions of capital are treated, how income derived by the entity is taxed and how distributions or withdrawals are taxed.

Table 5.1 – Generic Tax Treatment of Companies, Trusts and Partnerships

Type of Entity	Contributions	Income of the Entity	Distributions
Partnership	Capital contributions ignored for tax purposes.	Partnership income is attributed directly.	No separate tax treatment of partnerships means that, in substance, distributions are deductible up to the level of taxable profits; but, unlike companies and trusts, a partnership cannot carry forward losses or retain profits and pay tax on them.
Trust	Contributions of capital create a nexus with New Zealand if the settlor is resident.	Retained current-year income ¹⁴⁴ is taxed to trustee at 33 percent. Distributions of current-year income are effectively deductible (up to the trust income).	Current-year income is taxed as ‘beneficiaries’ income’ at their marginal tax rate if distributed or vested within a specified timeframe. Broadly, distributions of reserves are exempt (from ‘qualifying trusts’); taxed, except for corpus and arms-length capital gains (from ‘foreign trusts’); and taxed (except corpus) at a penal rate (from ‘non-qualifying trusts’).
Company	Subscription for shares can be distributed tax free.	Taxable income taxed at corporate rate. Dividends are non-deductible but carry imputation credits.	Distributions are taxable as ordinary dividends (subject to imputation), except where distributions can be attributed to subscribed capital (in a share repurchase or liquidation) or to capital gains (on liquidation). Except for the latter item, there is no flow through of company-level preferences to shareholders.

5.7 Table 5.1 highlights differences in the degree to which the tax system integrates the tax treatment of an entity with its beneficial owners in the case of partnerships, trusts and companies. We also note that the standard trust treatment is not materially different from the standard partnership treatment in that income and reserves can be allocated directly to beneficial owners.

¹⁴⁴ Income not distributed in the income year it is earned by the trustee or within six months of the end of that year.

- 5.8 There are currently a large number of entity-specific tax regimes. Some regimes have their own rules for calculating taxable income. However, all these regimes can be substantially aligned with either a partnership, company or trust treatment. The current entity-specific regimes can be categorised as in Table 5.2 below.
- 5.9 This table does not describe the detailed rules applying to all the entity-specific regimes noted. But the parallels between the underlying substance of these rules and the partnership, trust and company regimes highlights the potential to significantly reduce the number and complexity of entity-specific regimes.

Table 5.2 – An Overview of Existing Entity-Specific Regimes

Entity Regime	Sub-regime (if applicable)	In Substance Company/Trust/Partnership Treatment
Qualifying Companies		<i>Partnership/Qualifying Trust</i> – dividends (in effect) deductible/assessable, while non-taxed distributions from reserves are exempt when distributed to shareholders.
Controlled Foreign Companies		<i>Partnership</i> – the interposed entity is ignored and income/expenditure is attributed directly to shareholders.
Foreign Investment Funds	Comparative value income method	<i>Company</i> – dividends are taxable, no pass through of preferences, and taxation of capital gains.
	Branch-equivalent/ accounting profits income method	As for controlled foreign companies
	Deemed rate of return method	<i>Quasi-qualifying Trust</i> . The method appears to implicitly assume that income will not be distributed. Hence, is subject to estimation and tax is paid by owner (in a role similar to a trustee), with subsequent distributions from reserves exempt.
Co-operatives		<i>Qualifying Trust</i> – dividends are, in effect, deductible as per beneficiary income. Have option to pay non-deductible dividends as per standard company treatment if the co-operative wishes to attach imputation credits.
Statutory Producer Boards		As for co-operatives
Maori Authorities	More than 20 beneficiaries	<i>Qualifying Trust</i> – Retained income taxed at 25 percent. Distributions to beneficiaries are assessable to them but are, in effect, deductible to the authority but with ability to carry back resulting losses (that is, if distributions exceed net income) to any of the four immediately preceding income years.
	Less than 20 beneficiaries	<i>Partnership</i> – Maori authority is assessable on income derived as agent of each beneficiary in respect of her/his share of taxable income.

Table 5.2 – An Overview of Existing Entity-Specific Regimes

Entity Regime	Sub-regime (if applicable)	In Substance Company/Trust/Partnership Treatment
Unit Trusts		<i>Company</i>
Group Investment Funds	Category A income	<i>Company</i>
	Category B income	<i>Qualifying Trust</i>
Life Insurance Company	Income from life insurance business	<i>Company</i> – this regime applies to the <i>equity holders'</i> interests in the income of the life insurance company.
	Policy holder base income	<i>Company</i> – this regime applies to the <i>policy holders'</i> interests in the income of the life insurance company.
Superannuation Fund		<i>Qualifying Trust</i> – exception is that all income is taxed in hands of trustee (including current-year income of beneficiaries).
Close Company		<i>Company</i> – certain in-kind benefits and salaries to directors above a certain level are treated as ordinary dividends.

The Design Principles

- 5.10 The two broad approaches to the taxation of entities are to impose a tax on the entity *per se* (separate treatment) or to attribute the tax base of the entity directly to the beneficial owners (integrated treatment). From an economic viewpoint, entities are agents for their owners, implying that their tax treatment should be integrated with the tax treatment of those owners. Under an integrated or agency paradigm, transactions between an entity (or agent) and its owners (or principals) are ignored. The tax base of the entity is simply allocated to the owners in accordance with their property rights.
- 5.11 In practice, fully integrated models have been shunned in the case of widely-held entities and discretionary trusts. Taxing shareholders on profits of widely-held entities as they accrue would involve complex administrative and compliance costs in allocating income and identifying the marginal tax rates of owners. Further, abandoning withholding taxes on entities (which are in the economic substance of entity taxes) would materially heighten concerns over deferral, avoidance and evasion. And because discretionary beneficiaries do not have fixed entitlements to trust income, it would be impossible to measure or approximate the income of a discretionary beneficiary prior to an actual allocation by the trustee.
- 5.12 The Valabh Committee recommended the introduction of the qualifying company regime on the premise that closely-held companies were analogous to partnerships and should therefore be taxed on an integrated basis. Consistent with the integrated paradigm, management and ownership are typically located in the same people in

closely-held entities. We are inclined toward the same view, that closely-held organisations should be subject to an integrated tax model where integrated treatment is feasible. Conversely, the company tax model is preferable in the case of widely-held entities where management and ownership are typically separated and integration is infeasible. This widely-held approach is presently exemplified by the unit trust regime. Our preliminary recommendation is therefore to divide entities between widely-held and closely-held categories, applying the company model to the former and the integrated partnership model to the latter.

The Taxation of Widely-held Entities and their Owners¹⁴⁵

5.13 The relationship between owners and a widely-held entity is relatively detached. In substance, the owners are simply providers of finance. In a widely-held entity, there is usually a management team acting independently of its widely dispersed owners. The most predominant form of widely-held entity is a widely-held company.

5.14 The principal feature of the corporate tax is the dividend regime, the key elements of which are:

- an imputation mechanism (for resident-to-resident transactions);
- the taxation of inbound dividends (for non-resident-to-resident transactions);
- no pass through of exempt capital gains except on a winding up;
- targeted ordering rules for reductions in share capital;
- restrictions on qualifying subscribed capital; and
- taxing imputed benefits.

5.15 Our preliminary view is that the only fundamental area that should be considered for reform in the standard corporate model is whether a dividend deduction regime should supplement or replace the dividend imputation system.¹⁴⁶

5.16 A dividend deduction regime would be consistent with the current treatment of trusts. It operates more simply than a dividend imputation regime. It achieves an alignment of tax rates between an entity and the ultimate recipient of the dividend, and it still claws back tax preferences. It is also worth noting that a dividend deduction system would remove the sanction of the imputation debit for matters such as breaching shareholding continuity. Avoidance arrangements involving dividend access shares and warehousing to facilitate profit/loss transfers would also have to be specifically regulated.

¹⁴⁵ We canvass issues about how to define the boundary between closely- and widely-held entities in the table at the end of this chapter.

¹⁴⁶ If the risk-free return methodology outlined in Chapter Two, *Tax Bases*, was adopted, an alternative approach would be required. Alternative approaches are discussed in Annex A.

- 5.17 Under a general dividend deduction regime, New Zealand would effectively cede taxation of corporate income distributed as dividends to non-resident shareholders.¹⁴⁷ We have been advised that a wholesale shift to a dividend deduction regime would involve a fiscal cost of at least \$1 billion, largely due to lowering taxes on non-resident shareholders.
- 5.18 This cost could potentially be ameliorated by denying tax relief to non-residents by either:
- denying a deduction for dividends distributed to non-residents;
 - establishing (or extending) a deductible surrogate dividend concept, such as a rebate (that would be defined as a distribution to a resident recipient); or
 - increasing non-resident withholding taxes.
- 5.19 The latter strategy is constrained by New Zealand's existing double-tax agreements.
- 5.20 We therefore conclude that the imputation regime should be the default treatment for widely-held entities. We consider below the associated design challenges for some entities, such as trusts. However, some form of dividend deduction regime should be considered if it can be confined to resident shareholders. From an avoidance perspective, the Review would prefer that such deductions were capped by current-year taxable income, as generally applies to trusts.

Pass through of preferences

- 5.21 As noted earlier, there is usually a greater economic separation between widely-held entities and their owners. This separation is most typically reflected in the relationship between shareholders and the widely-held (often, listed) companies they own. The issue of whether tax preferences should flow from these companies to their shareholders was considered by the Valabh Committee in its report on the Taxation of Distributions from Companies in November 1990.¹⁴⁸
- 5.22 The Valabh Committee noted that shareholders receive their returns in the form of dividends and capital appreciation. If it were not for tax differences, such shareholders would be indifferent about the sources of their dividends. The Committee noted that shares are analogous to debt in this context. A person lending to a widely-held company would expect to be taxed on all the income derived, irrespective of whether or not any particular interest payment could be said to have been made from a tax-free source from within the company.

¹⁴⁷ Eliminating the company tax base would also result in New Zealand foregoing the benefits it currently obtains from the underlying foreign tax credit rules operated by countries that export capital to New Zealand. These rules can 'look through' to tax paid at the corporate level in New Zealand in assessing credits to set off against withholding taxes in foreign jurisdictions.

¹⁴⁸ Tax preferences include concessions specifically provided for in the tax system, losses incurred at the company level and unintended preferences due to weaknesses in the tax base.

- 5.23 The Valabh Committee concluded that the arms-length relationship between shareholders and widely-held companies meant that tax preferences should not flow through to shareholders. The Review endorses that conclusion.
- 5.24 As noted, however, current trust and partnership rules allow the flow-through of preferences (other than losses) to beneficiaries. This difference in treatment between companies and trusts would impose economic costs if widely-held trusts or partnerships were readily substitutable for widely-held companies as a form of business organisation.
- 5.25 Outside the professional services sector, widely-held entities that undertake ‘active’ businesses (for example, manufacturing or service-related activities) typically adopt the corporate form in New Zealand. This reflects the need for shareholders (and creditors, in the case of default) to have well-defined entitlements to the underlying assets and income of the company. Current tax rules also treat trusts as companies if rights and entitlements of contributors of capital are sufficiently well defined.
- 5.26 Superannuation funds are examples of widely-held entities that are subject to the trust rules. These entities tend to be long-term savings vehicles for their owners. The legal and institutional framework that applies to life insurance companies, registered superannuation funds and other widely-held long-term savings vehicles mean that tax considerations are unlikely to intrude unduly on choices about organisational form.
- 5.27 Nonetheless, widely-held entities taxed as trusts compete with widely-held entities taxed as companies (including unit trusts and life insurance funds) as vehicles for New Zealanders’ savings. The substitutability of interests in widely-held trusts and companies suggests that the same general rules should, in principle, apply to both. A more closely aligned treatment would reduce the economic costs outlined earlier. An implication is that there would be no pass through of preferences for both widely-held companies and trusts.
- 5.28 We recognise, however, that such a change would raise significant compliance and transitional rules for superannuation funds. The claw-back of preferences on distributions would mean that pensions would no longer be fully exempt, since payments funded from non-taxed sources (such as non-taxed nominal capital gains) would be taxed in the hands of recipients. This would require tracing and attribution rules. Accordingly, while in principle there is a case for not allowing preferences to pass through to beneficiaries of widely-held trusts, we wish to consider further the broader implications of such an approach for registered superannuation funds and we therefore invite submissions on this issue.

Application of the ‘default’ company imputation rules to trusts and partnerships

- 5.29 Can the imputation regime be applied to trusts and partnerships in order to better align entity taxation with the marginal rate faced by the entity’s beneficial owners? Trusts

have always posed difficulties in subjecting them to imputation regimes. Discretionary trusts in particular offer scope to stream imputation credits because:

- beneficiaries do not hold defined entitlements to the underlying income and assets of the trust. This makes it difficult to design effective anti-streaming and continuity rules; and
- unlike a corporate or partnership situation, contributors of capital (settlers) have no rights to returns of, or returns on, trust capital.

5.30 Widely-held discretionary trusts are rare in practice. Discretionary trusts are typically closely-held trusts. The monitoring and other transactions costs of a number of unrelated people dealing at arm's length with each other generally means that entitlements to the assets and income of any trust in which they hold an interest are better defined. In a widely-held context, a trust is more likely to be a fixed trust and subject to the unit trust regime.

5.31 Widely-held discretionary trusts that are deemed to be companies would require special rules with respect to continuity and available subscribed capital. However, we do not see any special difficulty in the application of the core imputation regime to actual distributions of benefits *ex post*, which would be deemed to comprise dividends. In broad terms, a widely-held trust would:

- be defined as a widely-held company for tax purposes;
- pay tax on all trust income; and
- attach imputation credits to its distributions.

5.32 Widely-held partnerships also tend to have relatively clearly defined property rights. Ownership of a partnership's assets vests in each partner in accordance with the contract between them. Likewise, the share of each partner to partnership income is often (but not always) defined. The imputation regime could therefore be extended to widely-held partnerships. In broad terms, a widely-held partnership would:

- be defined as a widely-held company for tax purposes;
- pay tax on all partnership income; and
- attach imputation credits to its distributions.

5.33 The Review would like to explore in more detail the implications of applying a company regime to widely-held partnerships and trusts and invites submissions on the issue.

The Taxation of Closely-held Entities and their Owners

5.34 A closely-held entity regime recognises the close economic connection between the owner and the entity. The partnership, qualifying company, controlled foreign company and close company regimes exemplify this approach.

- 5.35 The goal of a closely-held entity regime would be to minimise the extent to which taxpayer choice is influenced by differences in entity tax treatment. Accordingly, it is envisaged that:
- closely-held companies would be subject to the qualifying company and loss attributing qualifying company regimes, as currently;
 - closely-held partnerships would be subject to the existing partnership regime; and
 - closely-held trusts would be subject to the existing trust regime.
- 5.36 We consider that these three broad regimes are sufficiently closely aligned for their tax treatments not to unduly distort choices about the business form of closely-held entities.
- 5.37 Special rules would be required to address the following matters, namely:
- qualifying company election tax (QCET) upon a widely-held entity becoming a closely-held entity;
 - loss allocation in closely-held trusts; and
 - Guaranteeing entity income tax liability.
 - Distributions between and amongst closely-held and widely-held entities.
- 5.38 QCET is a feature of the qualifying company regime and is necessary to prevent taxable reserves within a company being rendered exempt simply by electing into the qualifying company regime. However, the transitional QCET issue for qualifying companies does not arise with trusts and partnerships because, unlike companies, trust and partnership reserves are not taxable at commencement. Once the regime is under way, however, widely-held entities could escape tax on their revenue reserves by becoming closely-held entities. On this basis, our preliminary recommendation is that any trust or partnership reserves at commencement of the regime that would not be taxable if distributed on that date would be deemed to not form part of their taxable reserves after commencement of the regime. Post-regime taxable reserves would, however, attract QCET if a widely-held partnership or trust became a closely-held partnership or trust.
- 5.39 We consider that loss allocation rules in respect of fixed closely-held trusts would be consistent with the LAQC regime. We do not consider that such a regime should be applied to discretionary closely-held trusts, on the basis that property rights are not sufficiently defined.
- 5.40 Given the compulsory nature of these partnership and trust proposals, we do not favour altering the existing rules regarding taxpayer liability or security with respect to trusts and partnerships.
- 5.41 Our preliminary views on the taxation of inter-entity distributions is that the existing standard treatments should apply. In other words, existing rules would apply to closely-held trusts, partnerships and qualifying companies, whereas the existing non-qualifying corporate treatment would apply to widely-held entities. Under this latter regime, inter-entity dividends would be exempt where the ultimate non-corporate ownership was the

same, but would otherwise be taxable and subject to the imputation system. These recommendations would be subject to our conclusions on dividend deductibility, discussed above.

5.42 Under these proposals, closely-held partnerships would continue to not be an entity taxpayer. All other entities would be taxpayers. As mentioned, the taxes paid by these taxable entities effectively comprise a withholding tax on their beneficial individual owners. Our preference is for entity tax rates to be aligned with the highest personal marginal tax rate in order to remove an artificial incentive to defer such tax rates by diverting earnings to entities or retaining earnings within entities.

5.43 These rules would provide a basic template for the design of future special regimes or the reform of existing special regimes. The qualifying company and unit trust regimes are examples of how these principles have been applied in practice.

Defining the Boundary Between Widely- and Closely-held Entities

5.44 The key principles in delineating between closely-held and widely-held entities are to:

- minimise the possibility for widely-held entities to characterise themselves as closely-held entities; and
- minimise the complexity of the definitions.

5.45 We have outlined a proposed approach in Table 5.3. We understand that most closely-held companies have not elected to become qualifying companies – which, we suspect, is because of qualifying company election tax (QCET) and the abandonment of limited liability in respect of income tax. For this reason, our preliminary view is to not compel closely-held companies to adopt the qualifying company regime, but to leave that regime voluntary, as at present.

Charities

Entities

5.46 Most charities are constituted as trusts and, accordingly, our proposals on the tax treatment of trusts will impact on the charitable sector. For example, if a charitable trust did not fit within the definition of ‘closely-held’, it would, under our proposals, automatically be treated as a company for tax purposes. While corporate treatment is not inconsistent with charitable status, structural issues would then arise regarding, for example, the nature of distributions made by charities. These issues would have to be resolved in a manner consistent with the government’s stated intention to continue to use the tax system to provide assistance to the charitable sector.

Submissions

5.47 We have received a number of submissions on the taxation of charities. The common themes in submissions relate to the definition of charity for tax purposes and, more specifically, the limits on deductions and rebates for donations to charities and the non-refundability of imputation credits.

The Government discussion document

5.48 The government last week released a discussion document, *Tax and Charities*, which deals with all the issues raised in submissions to this Review. We propose deferring our consideration of how our entity rules should affect charities until we have had time to fully consider these recommendations and the submissions on them.

Table 5.3 – The Boundary Between Widely- and Closely-Held Entities

Entity	Closely-held defined as ... (say)	Widely-held defined as ... (say)	Look through rules for closely-held	Transition into or out of closely-held regime	Key rules
Trusts	Five or fewer <i>sui juris</i> arm's length ultimate beneficiaries either have received distributions from the trust or have fixed interests in the trust's income. Beneficiaries within the 1 st degree of relationship would be counted as one person.	Not a closely-held trust	Shareholders of any corporate beneficiary would be included in beneficiary count. No widely-held company, widely-held trust or widely-held partnership would be able to be a beneficiary.	At outset, no need for equivalent of qualifying company election tax (QCET) to enter closely-held regime, since there will be no untaxed reserves. Untaxed reserves should be deemed to be available subscribed capital. ¹⁴⁹	Distributions to a new beneficiary will trigger change of status to widely-held.
Company	Existing qualifying company rules	Not a qualifying company	Same as qualifying company No widely-held trust or widely-held partnership would be able to be a shareholder.	Same as qualifying company	
Partnership	Five or fewer <i>sui juris</i> arm's-length partners. Partners within the 1 st degree of relationship would be counted as one person. A partnership where all partners are widely-held entities	Not a closely-held partnership	Shareholders of any corporate partner or the beneficiaries of any partner that is a trust would be included in the partner count. No widely held partnership, widely held company or widely-held trust would be permitted to be a partner.	At outset, no need for equivalent of qualifying company election tax (QCET) to enter regime, since there will be no untaxed reserves. Untaxed reserves should be deemed to be available subscribed capital.	The definition of a partnership for tax purposes would be extended to cover associations of persons that are co-investing or co-operating through agencies or syndicates under an integrated arrangement. Joint ventures would not be partnerships and would be treated as forming part of the principals' operations.

¹⁴⁹ Thereafter, an 'entry' tax if a widely-held trust (or partnership) becomes a closely-held partnership will depend on whether these entities are subject to the company (imputation) regime. If they were, then any untaxed 'revenue' reserves would be subject to a 'QCET'-type entry tax if the entities became closely-held.

CHAPTER SIX

INTERNATIONAL TAX: TAXING INCOME FROM INBOUND AND OFFSHORE INVESTMENT

International tax policy is about determining how to tax income earned by non-residents in New Zealand and by New Zealanders offshore.

New Zealand needs a sustainable regime to tax such income. Globalisation, with increasing mobility and complex business arrangements, makes this more challenging.

We believe reform is necessary and we set out various options.

Inbound

As regards taxing income from inbound investment to New Zealand, we believe a lower tax rate on New Zealand income of non-resident investors has merit. But the potential existence of significant current non-resident investors earning economic rents raises issues. We are considering a carefully targeted reduction to the company tax rate for non-resident investors. We want New Zealand to ‘stand out from the crowd’.

Outbound

As regards taxing New Zealanders’ foreign-sourced income, we believe the residence and see-saw principles provide insight as to the direction of national welfare maximising reforms.

But these principles need to account for the reality of New Zealand’s tax treaties, which require credits to be given.

In addition, mobility of significant businesses, people and entities means relativities to international standards are important in assessing the extent New Zealand’s regime produces excess burdens (deadweight costs of taxation).

We recommend repeal of the grey list, provided a satisfactory amended regime can be implemented.

We are considering:

A modified CFC regime adopting an active/passive distinction, together with a risk-free return method for portfolio listed investments (including unit trusts).

A more extensive adoption of the risk-free return method.

A 'domicile rule', which would reduce potential migrants' tax on their offshore investments.

We also question whether personal tax rates should move to 0 percent after a substantial annual tax liability (such as \$1 million) has been met.

We have not reached final views. Policy development will continue between now and the release of our final report.

Introduction

- 6.1 International tax policy is about determining how to tax income earned by non-residents in New Zealand (inbound investment or capital imports) and income earned from offshore by New Zealanders (outbound investment or capital exports).
- 6.2 International tax has been a controversial area of tax policy in New Zealand since 1988. This controversy has arisen for a number of reasons. First, the area is very complicated, perhaps the most complicated in all of tax policy. This is at the level of both policy analysis and tax rules. This complexity, which is necessitated by the subject matter, has not aided clear discussion of the policy alternatives. It has also restricted the range of participants in the debate to the core affected taxpayers, their advisors and a small group of policy advisors.
- 6.3 Secondly, the stakes involved are high. The amount of investment across all international borders is large and increasing. Affected taxpayers tend to be large corporations and high-worth individuals – the sorts of taxpayers who tend to be highly responsive to taxes. Governments see the area as important because of the effects international taxation can have on the structure of savings and investment within the domestic economy.
- 6.4 Finally, the novelty of some of the approaches that New Zealand has taken to taxing cross-border income has undoubtedly and naturally raised private sector concerns about the validity of those approaches.
- 6.5 Our approach has been to identify the broad principles that should be adopted in designing the rules for taxing income from inbound investment by non-residents and offshore investment by New Zealand residents. We have then outlined the policy options that we are considering for implementing these principles.
- 6.6 This chapter is arranged as follows: We first consider the economic theory that provides a framework for taxing inbound and offshore investment.
- 6.7 We then address specifically the taxation of inbound investment by non-residents. We outline the broad principles that the Review adopts and then address the policy options we are considering.

6.8 The taxation of outbound investment by residents is then specifically addressed. We then outline the different perspectives, principles and specific policy options that the Review is considering.

The Economic Theory and Framework for Taxing Inbound and Outbound Investment

6.9 The policy framework that follows, and indeed this whole chapter, is based on the assumption that New Zealand will continue to tax income from capital. As we explained in Chapter One, the ability of governments throughout the world to tax such income (particularly foreign-owned capital) is being challenged by increasing mobility and the complexity of modern business arrangements. We believe, however, that the time has not yet come for New Zealand to move away from taxing income from capital. Thus, sustainable regimes for taxing income from capital in an open economy – the subject matter of this chapter – remain a necessity.

Possible income tax bases for New Zealand

6.10 New Zealand, in common with any country, has four possible income tax bases to consider. The following chart shows those bases and whether they would be taxed under a system adopting the source or residence principles (these principles are described below).

Table 6.1 – The Four Tax Bases

Taxpayer	Source of Income	Taxed Under	
		Source Principle	Residence Principle
Residents	Domestic (NZ)	X	X
	Offshore		X
Non-Residents	Domestic (NZ)	X	
	Offshore		

6.11 Of these four bases, offshore income of non-residents is essentially beyond the reach of the New Zealand government except where such income is trapped inside a resident entity that is owned by a non-resident. Basic combinations of taxes on the remaining income streams are:

- tax both residents’ foreign-sourced income and non-residents’ New Zealand-sourced income;
- tax residents’ foreign-sourced income and exempt non-residents’ New Zealand-sourced income (residence principle);

- tax residents' New Zealand-sourced income only; and
- tax residents' and non-residents' New Zealand-sourced income (source principle).

Policy frameworks and economic models

6.12 Having identified the possible tax bases available to New Zealand, our task is to determine which base is the most appropriate to tax. This is the role of a policy framework: a way of making choices between alternatives, based on an idea about what is 'best' for New Zealand.

6.13 As we noted in Chapter One, *Frameworks*, throughout this whole issues paper, we are investigating and developing frameworks that are primarily economic in nature. The economic frameworks are used to try to identify the tax system that is best for New Zealand.

6.14 The use of an economic framework in the area of international tax – in particular, the relevance of the models that underlie much of the economic analysis in this area – has itself been a matter of some controversy.

Economic models simplify the real world

6.15 The economic models used as a basis of tax policy abstract from real world considerations; for example, they:

- focus on ultimate individual resident and non-resident investors. They 'look through' intermediate entities such as companies;
- assume that the residence of a taxpayer does not change in response to taxes;
- assume income is taxed as derived, rather than on repatriation;
- generally assume one form of investment subject to a consistent tax treatment. In the real world, there are a number of different instruments (for example, debt and equity) subject to different tax regimes; and
- generally address relationships between marginal effective tax rates, which are difficult to determine in the real world and which vary across industries and types of instruments.

6.16 That an assumption on which an economic model is built is not satisfied in the real world does not necessarily mean that the model cannot be used to provide guidance as to the direction of tax policy. Economic models are constructed for that very purpose – by simplification, they enable insights that would not otherwise be evident.

Policy in the real world may vary from that suggested by the model

6.17 However, it is obviously important when making real-world decisions to test whether the direction/particular policy suggested by the model is the most appropriate in real-world situations. In the real world, the result from implementing a particular

policy/direction suggested by the model may vary considerably from that suggested by the model. It is necessary to determine whether the simplifying assumptions in the model mean that the model suggests inappropriate policy conclusions when given real-world application.

- 6.18 Naturally enough, economists are likely to be more instinctively comfortable in applying the results suggested by their discipline. One of the communication difficulties experienced in the debate in the New Zealand context is that those who have engaged in the debate from business, legal and accounting backgrounds generally commence with a lower level of intuitive faith in the economics discipline and are not reassured when they discover the simplified models on which the analysis is based.
- 6.19 To engage in constructive debate, it is important that all parties have an understanding of the economic framework.

Taxing non-residents: the economic theory

New Zealand depends on capital inflows

- 6.20 As a small, open, capital-importing nation, New Zealand's economy depends on capital inflows for its development. Since the late 1980s, foreign direct investment here has been significant. Total foreign direct investment at 31 March 2000 is estimated to be \$63.8 billion, primarily from Australia, the United States of America and the United Kingdom. In the long run, good quality foreign direct investment should increase the economy's performance by introducing new technologies, management, expertise and access to world-wide product distribution systems.

Imposing taxes on non-residents makes New Zealand a less attractive place to invest: the residence principle

- 6.21 As a general principle, imposing taxes on non-residents makes New Zealand a less attractive place for them to invest, discouraging foreign investment.¹⁵⁰ Non-residents are often (though not always) indifferent between investing in New Zealand and investing elsewhere. They will be willing to invest funds in New Zealand only if they receive a return after paying New Zealand tax that is at least equal to the return they could have obtained from investing elsewhere. So, holding other things constant, higher New Zealand taxes will mean non-residents will require a higher before-tax rate of return from their New Zealand investments.
- 6.22 In particular:
- foreign providers of debt will require higher before-tax interest rates from New Zealand borrowers (or, equivalently, will explicitly require borrowers to compensate them for New Zealand taxes). Since foreign lenders are the likely marginal source of

¹⁵⁰ The tax is analogous to a trade tariff.

debt finance in New Zealand, taxes on interest paid to non-residents will result in market interest rates that are higher than they would otherwise be, raising the cost of capital to New Zealand firms generally, leading to less investment; and

- foreign buyers of shares in New Zealand companies will require higher (before-tax) yields on their investments, depressing equity prices and raising the cost of equity capital to New Zealand firms.

6.23 Using the parlance employed in Chapter One, *Frameworks*, while the *legal incidence* of (or statutory requirement to pay) taxes on returns to non-residents' portfolio investment in New Zealand may rest on non-residents, the *economic incidence* will invariably fall on New Zealanders: the tax will not make non-residents any worse off but it will leave New Zealanders worse off. New Zealand's economic position can be improved by imposing additional tax directly on the recipients who are already bearing the burden of the tax and removing or not imposing the distortionary tax on the non-resident, thus receiving the benefit of the higher level of foreign investment that follows.

6.24 So far as it goes, this analysis implies that it is actually in New Zealand's interests not to tax income derived from New Zealand by non-residents at all. The residence principle (which we address further below in the context of outbound investment by residents) suggests that income from investments in New Zealand by non-residents should not be subject to any distortionary tax in New Zealand.

6.25 There are, however, two important qualifications to this conclusion: situations where non-residents earn above-normal returns, or 'economic rents', from New Zealand; and the allowance by other countries of 'foreign tax credits' for New Zealand tax.

Economic rents

6.26 As well as portfolio investment, non-residents undertake considerable direct investment into New Zealand. Providers of foreign direct investment will also require a higher before-tax rate of return than they would have required had taxes been lower but, in this case, at least part of the economic incidence of the tax will often fall on the non-resident. In particular, providers of foreign direct investment will often invest in New Zealand precisely because they believe they can earn a higher return here than elsewhere. In these cases, they may not be deterred by (reasonable) taxes and the tax will not have adverse consequences for New Zealanders. In fact, a reduction in taxes would not necessarily increase foreign direct investment from existing investors; it may instead only increase their return.

6.27 Again using concepts introduced in Chapter One, *Frameworks*, the supply of certain foreign direct investment to New Zealand may be less elastic than the supply of portfolio capital, lowering the relative economic costs of taxing foreign direct investment.

Foreign tax credits

- 6.28 Many countries allow their residents to reduce their home country tax liabilities by the amount of any taxes paid elsewhere. In these cases, the tax rate charged by New Zealand will affect *where* the non-resident pays tax – in New Zealand or at home – but not how much tax they pay. If taxes imposed by New Zealand do not exceed the value of foreign tax credits allowed for the New Zealand tax by the taxpayer’s home jurisdiction, the tax will not have any effect on the cost of capital in New Zealand.¹⁵¹ Unless the non-resident is able to defer taxes imposed by its home jurisdiction, New Zealand will not gain any benefit from giving up its right to tax the non-resident’s income.
- 6.29 It would be in New Zealand’s interests to tax non-residents’ New Zealand-sourced income up to the point where New Zealand tax equalled the foreign tax credits available to non-resident investors, but not beyond. In practice, however, the effective availability of foreign tax credits varies across jurisdictions, types of investment and investors, making it impossible to apply this approach accurately. In particular, we note that:
- most jurisdictions that allow foreign tax credits tax foreign-sourced active business income of their nationals only when the income is repatriated. One effect of this is that non-resident investors will receive a timing benefit from low New Zealand tax rates while capital is retained here;
 - most jurisdictions that allow foreign tax credits impose restrictions that will ‘bite’ to varying degrees across taxpayers – some investors from a particular jurisdiction may be able to fully utilise foreign tax credits in respect of New Zealand tax, while others may not place any value on foreign tax credits; and
 - where the foreign jurisdiction maintains an imputation regime similar to New Zealand’s, that allows credits for domestic tax but not foreign tax to be passed through to shareholders, the ‘real’ value of foreign tax credits will be substantially less than their ‘face’ value.
- 6.30 The nature of foreign tax credits allowed by foreign jurisdictions varies according to whether the investment comprises debt or equity and according to whether the investor is a ‘portfolio’¹⁵² investor or a ‘direct’ investor. In general, portfolio investors will, at best, obtain foreign tax credits in respect of foreign withholding taxes but will not obtain foreign tax credits in respect of underlying company tax. Direct investors may obtain foreign tax credits in respect of both underlying company tax and withholding taxes. However, since interest is tax deductible, no underlying company tax is paid in New Zealand in respect of debt-financed investment.

¹⁵¹ Equivalently, the economic incidence of the tax will fall on the foreign treasury.

¹⁵² Definitions of foreign portfolio investment vary, but the most common approach is that it encompasses equity investments of less than 10 percent of voting interests.

Taxing residents on their foreign-sourced income: the economic theory

- 6.31 We now address the economic framework for taxing the income that New Zealanders earn offshore. An understanding of the current rules is important to participation in the debate in this area. We attach as Annex C an outline, in short form, of the current rules and proceed here on the assumption that Annex C is understood and the defined terms used there (such as CFC/FIF) are also understood.
- 6.32 As we noted in the introduction to this chapter, this has been a difficult area of tax policy for the last fifteen years. In the interests of bringing clarity and, we hope, finality to the policy debates, we have set out below a comprehensive discussion of the various arguments that have been presented to date.

The current policy framework

- 6.33 We begin by setting out the policy framework that is said to underlie the current regimes. We say “is said to” deliberately, since (as will become apparent) the current regime cannot, in fact, be said to derive from a strict application of any policy framework; it is too much of a compromise.

New Zealand’s national welfare

- 6.34 The simple notion underpinning the rules applying to income earned offshore by New Zealanders is that taxes paid to the New Zealand government contribute to New Zealanders’ overall well-being; taxes paid to foreign governments do not. Consequently, it is in New Zealand’s interest for New Zealanders to invest offshore rather than in New Zealand only where offshore investments yield a higher rate of return *after paying foreign taxes* than corresponding investments in New Zealand *before paying New Zealand taxes*. This concept has been explained in various government documents over the past decade and has been subject to considerable public debate.¹⁵³

Example 6.1

The New Zealand tax rate is 40 percent and the Singaporean tax rate is 30 percent. A New Zealand firm that has \$1000 to invest is choosing between an investment in New Zealand yielding 10 percent before tax and six percent after tax, and an investment in Singapore yielding 12 percent before tax but nine percent after payment of Singaporean tax.

From a national interest perspective, it is preferable that the taxpayer selects the New Zealand-based investment, for a return to New Zealand of \$100 compared to \$90 under the alternative.

Of the three common approaches to taxing foreign-sourced income, only one will yield this ‘correct’ result.

¹⁵³ See, for example, *Taxing Income Across International Borders: A Policy Framework* (1991), *International Tax: A Discussion Document* (1995).

If foreign-sourced income is tax-exempt, the taxpayer will choose the Singaporean investment over the New Zealand investment, for an after-tax return of \$90 rather than \$60.

If foreign-sourced income is taxable, but with a credit allowed for any foreign tax, the taxpayer will still select the Singaporean investment: on a return of \$120, the taxpayer's initial New Zealand tax liability would be \$48, reduced by the \$36 of Singaporean tax already paid to \$12. So the after-New Zealand tax return is \$72 compared to \$60 under the alternative New Zealand investment.

If foreign-sourced income is taxable, but with a deduction allowed for foreign tax (that is, foreign tax is treated as a deductible expense), the taxpayer will select the New Zealand investment: the New Zealand tax liability on the Singaporean investment is $(\$120 - \$36) \times 40\% = \$33.60$. So, the after-tax return on the Singaporean investment is $\$120 - \$36 - \$33.60 = \50.40 , which is now less than the after-tax return to the New Zealand investment.

The residence principle

6.35 The notion that New Zealanders should be taxed at the same rate on their world-wide income, subject only to a deduction for foreign taxes, is known as the *residence* principle. An implication of relying solely on the residence principle is that New Zealand would not seek to tax income derived in New Zealand by non-residents. For reasons suggested above, economists generally argue that taxing on a pure residence basis would achieve the best outcome for New Zealand.

World welfare and capital export neutrality

6.36 National welfare differs from world welfare in that what is good for New Zealand may not be the best outcome for the world. World welfare is likely to be maximised where investors choose the best investment available anywhere in the world, regardless of taxes. For the world as a whole, a tax dollar paid overseas is just as good as a dollar paid in New Zealand. If the New Zealand government's tax policy was primarily driven by the desire to increase world welfare, it should pursue an approach referred to as "capital export neutrality". This would equalise the tax treatment of income from domestic and foreign sources. In effect, New Zealand would be required to grant a credit for foreign taxes, even where the foreign tax rate exceeds that of New Zealand.

6.37 Even though capital export neutrality is not generally optimal from a national welfare viewpoint, it understandably remains the basis for most double-tax agreements. So, in some sense, all countries' tax policies make at least a partial concession to world welfare and thus refrain from purely maximising national welfare at the expense of the rest of the world.

The see-saw model: an attempt to address real world constraints

- 6.38 As a result of double taxation agreements entered into by New Zealand, the residence principle cannot be adopted in full by New Zealand – New Zealand is required to give certain credits for foreign taxes.
- 6.39 Moreover, the application of a simple residence-based approach to outbound investment would generate the most efficient outcome for New Zealand only if the domestic cost of capital were not affected by taxes on non-resident investors. As discussed in the section on inbound investment, New Zealand does impose taxes on non-residents, so this is unlikely to be the case. This suggests a second-best approach for tax policy, given that the residence principle cannot be fully implemented in the real world. This is usefully demonstrated by examples. If before-tax interest rates are grossed up to reflect taxes on foreign investors, application of the residence principle to New Zealanders' offshore investment will result in New Zealanders investing too much at home and too little offshore, as illustrated in the following example.

Example 6.2

New Zealanders are taxed at 33 percent on both their domestic and their offshore investments (foreign taxes are deductible). If there were no taxes, New Zealanders would be able to borrow from foreign lenders at 10 percent. However, New Zealand applies a 'net' tax rate on foreign investors of 10 percent (where 'net' refers to New Zealand taxes that represent a true cost to non-residents; that is, New Zealand taxes net of foreign tax credits). So, foreign investors will only lend to New Zealanders at 11.1 percent, leaving them with 10 percent after paying New Zealand tax.

Since the before-tax cost of capital to New Zealanders is 11.1 percent, the after-tax rate of return to a marginal investment in New Zealand is $11.1\% \times (1 - 33\%) = 7.44$ percent. New Zealanders will undertake investments offshore only if they generate at least the same after-tax rate of return as an investment in New Zealand. In turn, this implies investment will be undertaken offshore only if it yields 11.1 percent before New Zealand tax.

Consider an investment offshore that yields 10.5 percent. Non-residents would (New Zealand tax aside) be willing to lend to New Zealanders at 10 percent, so New Zealand as a whole would be better off if a New Zealand firm undertook the investment. But, as a result of the NZ tax on the foreign investor, which has driven up the New Zealanders' cost of borrowing, the after-tax return from that investment would be too low, the investment would not proceed and New Zealand would be worse off than it could have been.

- 6.40 Example 6.2 implies tax rates on New Zealanders' offshore-sourced income should not be set too high. The same reasoning implies, however, that tax rates should not be set too low.

Example 6.3

New Zealanders are taxed at 33 percent on their domestic investments and at 10 percent on their offshore investments (this might, for example, be net New Zealand tax payable after allowing a credit for foreign taxes). Again, if there were no taxes, New Zealanders would be able to borrow from foreign lenders at 10 percent. However, New Zealand applies a net tax rate on foreign investors of 10 percent, resulting in a before-tax cost of capital in New Zealand of 11.1 percent.

The after-tax rate of return to a marginal investment in New Zealand is still $11.1\% \times (1 - 33\%) = 7.44\%$ percent, which again represents the minimum after-tax rate of return New Zealanders require from offshore investments. Since the tax rate on offshore investment is 10 percent, New Zealanders will undertake investments offshore if they generate at least $7.44\% / (1 - 10\%) = 8.27\%$ percent.

It follows that it would be privately profitable for New Zealanders to borrow from non-residents at a net cost to New Zealand of 10 percent to invest offshore in assets yielding 9 percent. But all that's really happening is that taxpayers are, in effect, subsidising the offshore investment – New Zealand, as a whole, is effectively worse off by one percent multiplied by the amount invested.

The see-saw model: the need for balance in tax on outbound investment by residents and inbound investment by non-residents

- 6.41 So how high should tax rates on offshore investment be, at least according to the theory? The answer is that the average net New Zealand tax rate on New Zealanders' foreign-sourced income should be approximately equal to the tax rate on New Zealand-sourced income *less* the net effective New Zealand tax rate on income sourced by non-residents from New Zealand. This approach has been termed the see-saw principle¹⁵⁴, since it implies that, if one rate is high (for example, the tax rate on New Zealanders' foreign-sourced income) the other rate should be low (for example, the tax rate on non-residents' New Zealand-sourced income).

The theoretical ideal: policy implications

- 6.42 The key policy implications of this theoretical framework are:
- it is to New Zealand's advantage to allow a deduction for foreign taxes paid by New Zealanders earning foreign-sourced income, not a credit. This is because tax paid to foreign governments does not provide a direct benefit to the overall well-being of New Zealanders;
 - it is also to New Zealand's advantage to impose a uniform tax rate on all foreign-sourced income as it accrues, regardless of the source of the income or the nature of intermediary/entity that derives the foreign-sourced income. Providing different rates

¹⁵⁴ See Joel Slemrod, Roger Procter and Carl Hansen, 1997, 'The See-Saw Principle in International Tax', *Journal of Public Economics*, 65, pp 163-176.

or tax treatment for different entities and individuals and across different foreign jurisdictions can distort residents' offshore investment decisions; and

- the see-saw principle implies that the foreign-sourced income of New Zealanders should be taxed at a lower tax rate than domestic income to the extent that New Zealand's cost of capital is raised by taxes on non-residents earning New Zealand-sourced income. This implies a modification of the pure residence principle, perhaps by allowing a restricted credit for foreign taxes rather than a deduction.

6.43 The residence principle also suggests that the income from investment in New Zealand by non-residents should not be subject to a distortionary tax here. For example, where the tax imposed requires a non-resident to raise its required pre-New Zealand tax rate of return to achieve the same after-tax return, this simply results in taxes being passed through to New Zealanders (the incidence of the tax is not on the non-resident). The higher required rate of return resulting from the tax produces less investment in New Zealand and lower national welfare than when New Zealand does not impose tax. New Zealand's economic position can be improved by imposing additional tax directly on the residents, who are already bearing the burden of the tax, and removing/not imposing the distortionary tax on the non-resident, thus receiving the benefits of the higher level of foreign investment that follows.

6.44 New Zealand is a small, open economy, dependent on capital from around the world. This capital will chase the best available return throughout the world, after paying local taxes. So, as a general principle, imposing taxes on non-residents makes New Zealand a less attractive place for them to invest. In the simplified economic models, reducing the New Zealand tax on non-residents' New Zealand income from its existing level, as a general principle, would assist in raising investment and in producing economic growth in New Zealand.

6.45 In the long run, the before-tax cost of capital and before-tax returns in New Zealand will fall if distortionary New Zealand taxes on non-residents are reduced. New Zealand investments will need to offer only the risk-adjusted world rate of return to attract offshore investors.

6.46 In the world assumed by the economic models, adoption of accrual-based New Zealand taxation of offshore income earned by residents with only a deduction for foreign taxes paid produces the result that both maximises national welfare and leaves an investor in the position that it is neutral as a matter of its private return between investing onshore and offshore. If overseas investments were not taxed, residents would be faced with a choice between (New Zealand taxed) New Zealand investments and (New Zealand tax-free) offshore investments. Such a policy, encouraging residents to invest offshore, would reduce the benefits accruing from greater foreign investment into New Zealand. By subjecting offshore investment by New Zealanders to New Zealand tax in the same way as for onshore investment and treating the foreign tax as an expense, the residence principle seeks to achieve optimal levels of foreign investment while still encouraging residents to invest in New Zealand.

Tax rates of other countries

6.47 Finally, New Zealand does not exist in a vacuum. Tax policies, trends and rates of other countries towards inbound investment have an impact on New Zealand. Both domestic and non-resident investors will have regard to the overall tax charged on their investment. To this end, New Zealand should keep the tax rates charged by other countries in mind when setting its own.

Taxation of Income Earned by Non-Residents in New Zealand

The Review's views on appropriate frameworks for taxing non-residents

6.48 Our current thinking is that the appropriate framework for taxing non-residents investing into New Zealand is as set out below.

Inbound investment is generally sensitive to New Zealand tax

6.49 In the short term, the sensitivity of inbound investment to New Zealand taxes will vary. Debt finance is especially sensitive, with New Zealand borrowers often having to agree to compensate the foreign lender for any New Zealand withholding tax imposed. Foreign portfolio investment is also likely to be highly sensitive to the rate of New Zealand tax, since there are numerous highly substitutable investments in other jurisdictions.

6.50 The sensitivity of foreign direct investment depends, in part, on the nature of the investment. Investment that is directed primarily at the domestic market is likely to be less sensitive to New Zealand tax, because of the obvious fact that non-residents must invest here to exploit the local market. Investment that is directed more at international markets, for example the export of goods or services, is more likely to be responsive to New Zealand taxes, as the investor will have more choices as to the location of their investments.

A lower tax rate on inbound investment is desirable in theory

6.51 Subject to three significant reservations, the Review believes that lowering the tax rate on foreign equity investment is desirable. The effective New Zealand tax rate is already lower on non-residents than residents, as a result of lower New Zealand taxes on interest and other cross-border payments. It is desirable to reduce the disparity between New Zealand taxation of returns to non-residents from debt (currently 2 percent deductible approved issuer levy (AIL) or 10 percent non-resident withholding tax (NRWT)) and equity investment (a current statutory rate of 33 percent; lower effective rate as a result of interest and other lower taxed cross-border deductions). We believe this should, in principle, be achieved by lowering the tax rate on non-residents' equity investment.

6.52 We anticipate that those working from an international competitiveness perspective would support this choice of direction. In this sense, the overall direction that the tax system should take in the area of inbound investment does not appear to us to be as controversial as the direction for the taxation of offshore investment addressed below.

6.53 We have three provisos regarding this analysis.

First proviso: the availability of foreign tax credits

6.54 Where the non-resident's home country grants tax credits for New Zealand tax paid, New Zealand should impose tax. Different countries will grant different levels of credit. An appropriate response that would maximise national welfare is for New Zealand to levy tax to the extent where credits can be expected, on average, to be available. The availability of foreign tax credits only in some cases also suggests that AIL-type mechanisms for equity investments can be beneficial. Where a non-resident investor can obtain a tax credit for New Zealand tax paid, then the non-resident will choose to pay New Zealand tax, but will pay a lower rate of AIL if no credits are available.

6.55 This analysis needs to be tempered, however, by the fact that the key countries investing into New Zealand would allow accumulation in New Zealand and other foreign countries of earnings at low New Zealand tax rates. So, non-resident investors would benefit from deferral of foreign tax by investments into New Zealand if New Zealand offered a low tax regime. This would apply regardless of the credit position. In addition, in practice, it should generally be assumed that non-resident multinational companies are usually concerned to try to minimise New Zealand tax, even if they can use credits. This is because their foreign tax credit position may change as a result of economic circumstances or by virtue of a change in foreign tax credit rules in their home country.

Second proviso: economic rents may reduce the benefit of tax reduction

6.56 Although official statistics do not directly record the use of foreign direct investment, they do support the conclusion that foreign direct investment in New Zealand has historically tended to be by multinational companies seeking to exploit opportunities in the New Zealand market. To date, the pattern of foreign direct investment here has not been one of non-residents investing in New Zealand as a base for exporting from New Zealand. This suggests that it is quite likely that significant economic rents are earned relating to exploitation of the New Zealand market. We have concerns that, to the extent this is the case, any reduction in New Zealand tax may primarily increase the after-tax returns, including super profits, of multinational companies, rather than enhance national welfare. The desired reduction in the cost of capital in New Zealand and additional investment here may not fully materialise. The Review is currently working through the extent to which its eventual policy recommendations should reflect this concern.

Third proviso: New Zealand-owned business faces higher taxes than overseas-owned business

- 6.57 In economic theory, provided that all income is taxed, then a tax system whereby New Zealand residents face a higher tax rate than non-residents should not prevent New Zealand residents from making investment here. Both resident and non-resident investors will demand those investments with the highest after-tax return and the decision of residents to invest locally is not distorted. However, other things being equal, the non-resident investor will generate a greater after-tax return than the New Zealand investor from the identical investment.
- 6.58 New Zealand's current tax rules already provide significantly lower effective tax rates on non-residents than on residents, primarily through the NRWT and AIL rules applying to interest. These rules enable non-residents to obtain debt finance at a lower after-tax cost than is available to residents. The Review has no evidence that the effective lower tax rates for non-residents have made a significant impact on New Zealand business, but would be interested to receive submissions on this subject. Reducing the headline corporate tax rate applying to non-residents, for example, would be a more transparent reduction in the effective tax rate but not a fundamental change to the existing position.

The current rules compared with the framework

- 6.59 New Zealand has already made considerable progress in reducing the domestic cost of capital by lowering the rates of tax imposed on non-resident debt investment (through the introduction of the approved issuer levy (AIL) rules) and equity investment (through the introduction of the foreign investor tax credit (FITC) rules).

Portfolio investors

- 6.60 To minimise tax imposts, non-resident portfolio investors – those owning less than a 10 percent stake in a New Zealand company – are taxed under the AIL regime on their non-residents' debt investments and under the FITC regime on their equity investments.
- 6.61 Under the AIL rules, so long as lending is not between associated persons, a New Zealand borrower can elect to pay a 2 percent levy (AIL) instead of NRWT, generally of 10 percent. Since foreign countries that allow foreign tax credits do not generally allow a credit for AIL, it makes sense for lenders to elect to pay AIL anytime a foreign lender is unable to reduce its home country tax liability by the amount of NRWT paid in New Zealand, but to otherwise pay NRWT. The end result is that the effective New Zealand tax rate – the tax for which non-residents require compensation – on non-residents' debt investment in New Zealand is, at most, 1.34 percent.¹⁵⁵

¹⁵⁵ The two percent AIL is tax deductible to the borrower, resulting in an after-tax cost of $2\% \times (1 - 0.33) = 1.34$ percent.

- 6.62 The FITC regime recognises that portfolio shareholders, who do not have any control over a company, are generally not allowed credits for company tax but may be allowed credits for withholding tax. Consequently, company tax constitutes a ‘cost’ for which the non-resident will seek compensation, but the withholding tax may not be such a cost.
- 6.63 The effect of the FITC regime is to apply a tax rate of 33 percent on non-residents’ New Zealand equity returns, but to divide this rate into a 21.18 percent company tax rate and an 11.82 percent dividend withholding tax rate.¹⁵⁶ For non-residents who are unable to obtain home country credits for dividend withholding tax, the regime’s introduction was effectively equivalent to New Zealand reducing dividend withholding tax to nil. Such investors face a New Zealand tax cost equal to the company tax rate.
- 6.64 But for non-resident investors who have access to foreign tax credits for New Zealand dividend withholding tax, the effect of the regime is to reduce their New Zealand tax cost to 21.2 percent.¹⁵⁷ (Non-resident suppliers of foreign direct investment who receive full foreign tax credits for both New Zealand dividend withholding tax and for New Zealand company tax do not incur any effective New Zealand tax cost.)
- 6.65 The second conclusion – that debt and equity are substitutable ways of financing foreign direct investment – is reflected in the thin capitalisation regime. Under the thin capitalisation rules, non-residents are (broadly speaking) able to deduct interest expense only to the extent that debt does not exceed 75 percent of the total capital requirements for an investment. In very simplistic terms, this means that non-resident providers of foreign direct investment can, by adopting an appropriate capital structure, ‘help themselves’ to a weighted average New Zealand tax rate considerably lower than 33 percent. A rough estimate of the range of the maximum weighted average effective New Zealand tax rate is 15.75 percent to 21.5 percent. The 15.75 percent is calculated assuming 75 percent associated party debt–financing (that is, no natural level of external debt), as follows: $(0.75 \times 10\%) + (0.25 \times 33\%) = 15.75$ percent.¹⁵⁸
- 6.66 Assuming a natural level of external debt to equity ratio of, say, 50:50, the non-resident can capitalise the company’s 50 percent external debt, 25 percent related party debt and 25 percent equity. Ignoring yields, the weighted average effective tax rate on the non-resident’s investment is $(.5 \times 10\%) + (.5 \times 33\%) = 21.5$ percent.

¹⁵⁶ Dividend withholding tax is typically levied at 15 percent of the cash dividend. A company that earns \$100 before tax and pays tax at 21.18 percent can pay a cash dividend of \$78.80. $15\% \times \$78.80 = \11.82 , or 11.82 percent of the company’s before-tax income. Total tax paid is $\$21.18 + \$11.82 = \$33$.

¹⁵⁷ This analysis is before the non-resident considers other methods of repatriating profits with little New Zealand tax, such as royalties or management fees. Therefore, the actual tax impost may be below this figure.

¹⁵⁸ This calculation assumes interest expense is subject to NRWT at 10 percent (interest paid to related parties does not qualify for AIL). The calculation, and that of the 21.5 percent, is over-simplified in several respects: it does not allow for differences in yields on debt and equity; it does not allow for any avoidance behaviour by non-residents, which may reduce the weighted average rate; and it ignores the value of foreign tax credits.

Summary of current treatments

6.67 Table 6.2 sets out the ranges of effective tax rates that currently apply to non-residents.

Table 6.2 – Effective Tax Rates Applying to Non-Residents

	Minimum ETR (%)	Maximum ETR (%)
Portfolio investment:		
– Debt	02	1.343
– Equity	22.184	335
Direct investment (weighted average)	06	Rough estimate 15.75 to 21.57

Notes

1. All calculations assume the underlying effective New Zealand tax rate is 33 percent. Discrepancies in the tax base (see Chapter Two) mean this will, in general, be only approximately correct.
2. Assumes full foreign tax credits available for interest NRWT.
3. Assumes AIL paid.
4. Assumes full foreign tax credit available for dividend NRWT; no foreign tax credits for underlying company tax.
5. Assumes no foreign tax credit available for dividend NRWT.
6. Assumes full foreign tax credit available for interest and dividend NRWT and for underlying company tax.
7. Assumes no foreign tax credits available.

6.68 However, it is apparent from the table that effective tax rates on non-resident investors are still somewhat disparate. Of particular interest is the difference between the rates applying to investment by way of debt and equity. Equity investment is taxed significantly higher than debt, both for foreign direct investment and portfolio investment. This difference distorts the relative costs of equity and debt finance to New Zealand firms, potentially leading (for some firms) to an over-reliance on debt. It would, in our view, be highly desirable to introduce measures that narrowed this difference by reducing effective tax rates on investment in equity instruments. This should be considered both for foreign direct investment and for portfolio investment. While the difference is likely to be greater for portfolio investment (assuming that foreign direct investment uses a weighted average approach to debt and equity), at this stage we are more convinced of the benefits of reducing taxes on foreign direct investment due to the potential advantages to New Zealand from additional direct investment.

Policy options

6.69 In summary, we believe there are potential advantages to be had from:

- reducing somewhat the average effective tax rate on foreign direct investment. This will provide an important signal to overseas investors that New Zealand values their long-term commitment and is prepared to provide an environment where foreign direct investment is not deterred; and

- narrowing the current disparity in effective tax rates on portfolio debt and equity, by taking steps to reduce the effective tax rate on equity (we also address below the possibility of increasing the effective tax rate on debt).

6.70 We have not yet formed a view on the extent to which effective tax rates should be reduced. We would particularly welcome submissions on this matter. In terms of being an attractive location for foreign investment, we believe it may be important for New Zealand to have a regime that ‘stands out from the crowd’.

Reducing effective tax rates on direct investment by non-residents

6.71 We have identified three broad approaches to reducing the average effective tax rate on direct investment by non-residents:

- a targeted reduction in the company tax rate to the extent New Zealand companies are owned by non-residents;
- a more limited reduction in the company tax rate applying only to a subset of non-resident investors; and
- making the taxation of portfolio investment more uniform.

6.72 We have also considered two other possibilities, which we do not, at this stage, propose pursuing:

- a modified thin capitalisation regime; and
- a significant reduction in the general corporate tax rate as a means of reducing tax on non-residents.

A targeted reduction in the company tax rate to the extent New Zealand companies are owned by non-residents

6.73 Relative to other ways of reducing effective tax rates on non-residents’ investment into New Zealand, a reduction in the company tax rate for companies owned by non-residents has the considerable advantage of being markedly more visible and therefore more clearly establishing New Zealand’s receptiveness to foreign investment.

6.74 The main issue to be decided before proceeding with such a reduction is whether it would actually benefit New Zealand. If non-residents currently investing in New Zealand are mainly earning economic rents related to New Zealand markets, then a reduction in tax for all non-resident investors might be an expensive means of generating an increase in foreign direct investment at the margin.

6.75 We set out in Annex D a possible approach to implementing a targeted reduction in the company tax rate to the extent a company is owned by non-resident investors. As well as comments on the general desirability of a targeted reduction for non-resident investors, we seek submissions on this particular approach. Although we have not yet decided on a particular rate, we anticipate that, if we were to recommend this approach,

the recommended reduction would be to a level between 15 and 20 percent. The implementation of a targeted reduction would be somewhat complex. We doubt whether the additional complexity that it would introduce to the tax system would be worthwhile unless there is a significant increase in investment into New Zealand. Our initial view is that, if this approach were to be recommended, the lower rate should be at least 10 percent below the general company tax rate.

Fiscal impact of this option

6.76 We have given some initial thought to the fiscal impact of this option. Assuming the existing company tax rate, and without making any other major changes to existing rules, a one percent change in the non-resident rate of company income tax will reduce government tax revenue by approximately \$45-50 million. This estimate assumes that New Zealand corporations are, in aggregate, 33 percent owned by non-residents and does not make any allowance for economic growth as a result of the tax cut. It becomes progressively less precise the more the non-resident rate is reduced. For illustration, consider the following:

Table 6.3 – Fiscal Impact of a Lower Company Rate for Non-Residents

General Company Rate	Lower Rate for Non-Residents	Estimated Reduction in Tax Revenue \$ million
33%	15%	855
33%	20%	617.5
33%	25%	380

Income tax reduction for certain foreign investors only

6.77 It may be that, following further consideration, the existence of significant super-profits for non-resident owned operations in New Zealand results in a general reduction for all non-resident owned companies being viewed as an inefficient means of attracting further investment to New Zealand by non-residents. The issue is whether the additional marginal investment attracted justifies the tax foregone to super-profit earners, when tax foregone does not result in any significant increase in their investment.

6.78 If a reduction addressed to all non-resident owned companies is not recommended, the Review believes that consideration should be given to New Zealand sending a signal through the tax system designed to attract non-resident investors by establishing a regime that stands out from those of other mid-range tax countries. Although not entirely consistent with the economic framework outlined, this signal could have a significant impact in practice.

6.79 Possibilities include a tax reduction that applies only to:

- foreign equity investment in new productive activities; that is, existing foreign equity investment would not qualify, nor would new investment into existing businesses. This would put emphasis on attracting investment in new productive activities to New Zealand;
- foreign equity investment in new productive activities in export industries, rather than exploitation of the New Zealand market; and
- foreign equity investment in new productive activities in certain industries or in certain regional development zones.

6.80 The Review is unlikely to favour the first approach since there are good reasons for applying any change to both old and new investments.

6.81 First, at a theoretical level, although the proposal may generate new investments, these may not always improve New Zealand's welfare. For example, imagine a non-resident holding an old investment generating a before-tax return of \$150; if they held that investment and faced 33 percent tax, they would receive \$100. Imagine the same non-resident has a new investment opportunity, of the same amount of capital. This investment generates a return of \$130 before tax. If New Zealand kept the tax rate at 33 percent on the old investment and allowed a 20 percent tax rate on the new investment, the non-resident could receive a post-tax return of \$104 on the new investment. Non-residents would seek to move existing investment into the new assets yielding the highest after-tax return, even though these yielded lower returns overall to New Zealand. This would not benefit New Zealand.

6.82 In addition, firms would have strong incentives to re-characterise existing investments as new investments for tax purposes. It may be difficult to design rules that limited the fiscal cost.

6.83 The Review will investigate further the possibility of a low tax rate primarily for new foreign-owned businesses in certain types of industries (or, possibly, export development zones for certain industries). This could be viewed as an experimental approach. Again, however, such an approach is not consistent with the general principles on incentives developed in Chapter One, *Frameworks*. If we were to recommend a targeted tax reduction along these lines, it would be designed to attract capital investments that would not otherwise be made in New Zealand, in certain designated industries and geared towards exports rather than exploitation of the New Zealand market. We would also ensure that any tax approach complied with New Zealand's international obligations; in particular, those arising from membership of the World Trade Organisation and involvement in the Organisation for Economic Co-operation and Development's Harmful Tax Competition project.

Making the taxation of portfolio investment more uniform

- 6.84 Given that supply of debt investment is highly elastic, we believe that a material increase in effective tax rates on interest paid to non-residents is not an appropriate way of narrowing the current disparity in returns to debt and equity. We do note in this context, however, that the existing AIL may be too low, in the sense that some borrowers may be choosing to pay AIL even where the lender has access to foreign tax credits, simply to avoid the costs associated with obtaining a foreign tax credit. If this is the case, there may be some merit in a small increase in AIL, perhaps to three percent, which equates to two percent after tax.
- 6.85 There are many possible ways of reducing effective tax rates on returns to portfolio equity investment. Some would be consequences of other policies, like a reduction in the company tax rate, either across the board or in respect of income attributable to non-resident shareholders. Others might be deliberately targeted at non-residents, like reducing the NRWT rate on dividends.
- 6.86 The important design criterion is that the proposals actually apply a reduction in taxes to non-residents (rather than, say, simply transferring revenue from New Zealand to other governments).
- 6.87 We set out below two options, targeted specifically at non-resident portfolio investors, that we think warrant further consideration.

Introducing an approved issuer levy regime for dividends

- 6.88 Under this approach, companies paying supplementary dividends would have a choice of paying NRWT or an AIL, probably set at the same level as the AIL applying to debt.

Increase the foreign investor tax credit (FITC) for portfolio investors

- 6.89 When it was first introduced, the FITC regime applied only to portfolio investors, defined as those owning less than 10 percent of a New Zealand company. This was because the government of the day considered that such investors were likely to be most responsive to New Zealand company taxes, which is what FITC reduces.
- 6.90 The effect of the current FITC rule is that the combined level of New Zealand company tax and NRWT on dividends equals 33 percent. There is, however, no reason why 33 percent is an appropriate benchmark; as we have noted above, there is probably no reason why New Zealand should tax non-residents at the same rate as residents.
- 6.91 It would be a relatively simple matter of drafting to increase the level of FITC, and thus reduce the level of New Zealand tax imposed on non-residents.
- 6.92 We note that a case can be made for implementing both the AIL and increased FITC proposals, as they are each targeted at separate components of the effective tax rate on non-resident portfolio investment.

The Thin Capitalisation Regime: at this stage, not to be pursued

6.93 One way of reducing the average effective tax rate on non-residents' investment in New Zealand is to increase the ratio of debt to assets beyond which interest expense is effectively non-deductible, under the thin capitalisation regime. The advantage of this approach is that it involves a simple adjustment to an existing regime and can therefore be implemented very easily. The disadvantage is that it does not involve any change to the 'headline' statutory tax rate faced by non-residents and will therefore be markedly less effective at distinguishing New Zealand from other jurisdictions.

6.94 We do, however, recommend retention of thin capitalisation rules and retention of NRWT on interest paid between associated parties at 10 percent. It is also desirable to clarify that certain back-to-back arrangements inserting non-associated parties between an ultimate non-resident associated lender and a New Zealand borrower do not qualify for the two percent AIL. We are also considering whether it is practical to amend the NRWT rules to ensure that an AIL or NRWT liability is triggered whenever a New Zealand borrower is accruing an interest deduction.

A significant reduction in the general company tax rate as a means of reducing tax on foreign investments: at this stage, not to be pursued

6.95 We explained in Chapter Four, *Tax Rates*, that we do not recommend an across-the-board reduction of the company tax rate significantly below the top personal marginal tax rate. It would not be well targeted as a means of reducing the tax burden for non-resident investors and would potentially carry a significant fiscal cost.

Questions we'd like you to consider

- (a) Would lower taxes on foreign-owned businesses have an adverse impact on New Zealand businesses?
- (b) How much would a lower tax rate for foreign investment make New Zealand 'stand out from the crowd'? Would it attract significant new investment?
- (c) Should New Zealand consider special tax regimes for certain forms of foreign investment, like investment into particular industries?
- (d) To what extent would an increase in AIL reduce its use?

Taxation of New Zealanders' Foreign-Sourced Income

6.96 We have already addressed at a theoretical level how New Zealand should tax the income that New Zealanders earn offshore and have outlined the current rules in Annex C. As already noted, New Zealand's current international regime is a compromise. It does not fully implement the economic theory suggested by the residence and see-saw principles. Similarly, it does not reflect the position for which business interests argue under the banner of international competitiveness.

Changes needed to apply the economic theory in practice

6.97 If New Zealand were to seek to apply the framework suggested by economic theory, the following changes would be required to the current regime:

- repeal of the grey-list exemption from the CFC and FIF regimes. At present, approximately 80 percent of all foreign investment by New Zealanders is into grey-list countries. The grey-list regime promotes investment into high-foreign-tax jurisdictions and away from low-tax jurisdictions, the latter potentially producing greater national benefit for New Zealand because of the lower level of foreign taxes imposed;
- generally, eliminate all credits for foreign taxes other than those granted by New Zealand's tax treaty network and, instead, just allow a deduction for foreign taxes. The underlying foreign tax credit would not be allowed in respect of FDWP for New Zealand companies owning 10 percent or more of a foreign company, and foreign taxes on income attributed from CFCs prior to repatriation would be deductible rather than creditable; and
- eliminate, where possible, differences in tax rules applying to offshore investment relative to investment in New Zealand. In this context, we note that the FIF regime frequently results in taxation of gains on shares in non-grey-list countries on an accrual (that is, unrealised) basis. In stark contrast, New Zealand does not, at present, impose any tax on such capital gains in respect of shares in New Zealand companies or grey-list companies. Under strict application of the framework, this discrepancy would be removed.

6.98 Under the theoretical framework, the following features of the current regime would be retained:

- income of a foreign branch of a New Zealand company would continue to be taxed as derived (that is, on an accrual basis), since the New Zealand tax treatment should be similar whether an investment is made by creating an offshore branch of a New Zealand company or by investing in an offshore company; and
- any credits for foreign taxes would continue not to be passed through companies; that is, only imputation credits should be able to reduce tax liability on dividends to shareholders and imputation credits should arise only for New Zealand taxes actually paid;

- this feature of the current regime has the effect that, on external distribution to shareholders, foreign tax credits are clawed back. So, any reduction in the foreign tax credits granted at the company level can be viewed as primarily being of a timing nature (it being acknowledged that timing of tax is important to all concerned). We believe that New Zealand's approach in not passing foreign tax credits through companies is similar to that of other countries. Our impression is that this is accepted by the business sector; and
- for the moment, we put aside the bilateral efforts to deal with the 'triangular' issue with Australia.

Business interests and international competitiveness

6.99 From submissions to the Review and our own experience of the debates to date, it is clear that many taxpayers have an alternative view of the appropriate framework for taxing foreign-sourced income.

6.100 New Zealand's CFC and FIF regimes are already more far-reaching than any other such regimes in the world. Other countries, almost universally, have narrower CFC and FIF regimes, targeted at countering tax avoidance. Some argue that New Zealand businesses are consequently placed at a competitive disadvantage relative to foreign businesses. Under this view, New Zealand's CFC and FIF regimes should be redrawn more in line with international norms.

6.101 New Zealand business interests are suspicious of the simplified economic models and claim that they do not provide appropriate guidance in the real world. In part, this view reflects the reality that New Zealand companies, high-net-worth entrepreneurs and highly skilled labour are mobile factors that are responsive to tax burdens. Business interests note that New Zealand's CFC and FIF regimes can discourage companies/individuals considering moving to New Zealand and create competitive disadvantages for those companies/individuals based in New Zealand and looking to invest offshore.

6.102 An approach to international tax policy that relied more on adopting international norms and addressing the concerns raised above might involve the following:

- repeal of the unrealised capital gains tax for non-grey-list investments under the FIF regime (particularly given the absence of such a tax on gains on New Zealand equity investment or grey-list investments);
- targeting the CFC/FIF regime at the legitimate avoidance concerns that would arise if New Zealand resident companies and individuals could escape or defer New Zealand taxation by moving passive income offshore. Only passive income would be taxed in New Zealand on an accrual basis (that is, as derived, regardless of what entities are interposed);
- this approach would involve introducing an 'active/passive' distinction. The foreign entity's activities/income would need to be categorised as active or passive.

Other countries' experiences suggest that this is a reasonably complex distinction to enact (but all have chosen to attempt it). Under the CFC regime, income would be attributed to the New Zealand shareholder only if the CFC income fell in the passive category. For CFCs whose activity or income met the active test, New Zealand tax would arise only on repatriation of profits to New Zealand. Another possibility, either as an alternative or complementary approach, would be an expanded grey list;¹⁵⁹

- as regards minority interests in foreign companies other than CFCs, the need to address rules to prevent deferral of New Zealand taxation of passive income derived through such entities would be acknowledged; and
- retention of tax credits for foreign taxes on a basis broadly consistent with those granted under the current regime.

Key design issues

6.103 The key design issues can be discerned by comparing the contrasting approaches suggested by the economic theory and by the business sector's focus on international competitiveness. Those design issues are as follows:

- (a) **Timing of Income Inclusion:** Should offshore income of residents be included in the New Zealand tax calculation when derived offshore (the 'accrual' basis; that is, at the same time as New Zealand-sourced income is taxed) or only when it is repatriated to New Zealand? Should the rules be the same for all types of income or should there be an active/passive differentiation?
- (b) **Availability of Foreign Tax Credits:** Where not required to do so by New Zealand's double-tax agreements, at the time when offshore income is taxed in New Zealand, should New Zealand unilaterally allow tax credits for foreign tax paid and, if so, to what extent?
- (c) **Taxation of Capital Gains:** Are special rules for taxing capital gains required for offshore equity investments in non-grey-list countries, as compared to New Zealand investments and grey-list investments?

Principles to follow in designing a tax system for offshore investment by residents: the Tax Review's approach

The residence and see-saw principles

6.104 In a world where individuals and entities do not change residence and where other countries apply similar principles, we accept the logic of the models' implication that, if New Zealand does not levy any net tax on non-residents' investment into New Zealand, it should allow only a deduction for foreign taxes.

¹⁵⁹ A distinction might be drawn under this approach according to whether the foreign company was located in a high-tax jurisdiction or a low-tax jurisdiction. We also note issues around the quarantining of CFC tax losses would need to be addressed.

- 6.105 However, the tax treaty network means that New Zealand and other countries cannot readily implement the residence principle, because tax credits are required to be allowed under tax treaties. It simply is not an option for New Zealand expressly to resile from its treaties or otherwise abandon its treaty network.
- 6.106 Moreover, the see-saw principle is not capable of application with mathematical precision in the real-world context. In particular, there are real difficulties in identifying the extent of foreign tax credits in other jurisdictions for New Zealand taxes and, even if obtainable, the results would not be uniform across jurisdictions or taxpayers. Accordingly, foreign investors do not face a single, uniform, net effective New Zealand tax rate on their New Zealand-sourced income. In principle, it would, in any event, be sufficient to determine the implicit impact on the cost of capital faced by New Zealand firms of taxes imposed on non-residents. But, even here, there is not a single non-resident tax rate because of the differing burdens of New Zealand tax on differing instruments and types of investment.
- 6.107 Nevertheless, the model provides powerful insights. It suggests the need for some measure of balance in the New Zealand tax on residents' offshore income and that on non-residents' income. This can be seen from the extreme case of no tax on non-residents' New Zealand-sourced income and no tax on residents' offshore investment. Non-residents would invest into New Zealand in large quantities and residents would move their capital offshore, with the New Zealand investment income tax base largely being eliminated.

Mobility of factors/excess burden as a framework for International Competitiveness

- 6.108 We know, however, that people and the entities they own can and do change residence. In Chapter One, *Frameworks*, we introduced the concept of excess burden (deadweight losses) and explained its connection with factor mobility. Although business interests think loosely in terms of international competitiveness, dialogue with economists is best achieved on the basis of excess burden.
- 6.109 All taxes produce excess burden (distortions from taxes that produce welfare losses). In the last 10 years, people (particularly the wealthy and highly skilled) and companies have become increasingly mobile across jurisdictions. New Zealand needs to be careful in designing its tax regime to minimise excess burden. This can arise both in the form of projects/non-residents that would have come to New Zealand but saw our tax system as a barrier, and in the form of residents leaving New Zealand for tax reasons. This framework suggests the possible need for lighter taxation of the most mobile contributors to the New Zealand tax base. We can evaluate the international competitiveness argument from this perspective. Where New Zealand seeks to tax more aggressively in a particular area than an international 'standard' and produces significant excess burden as a result, the question needs to be asked: can tax be raised more efficiently by applying a higher level of tax in another area and avoiding the excess burden that would otherwise arise by trying to tax the more mobile and tax-

sensitive entities/activities? However, as stated at paragraph nine, we believe that New Zealand should continue to tax this income in some form.

6.110 While maintaining a strong preference to maintain the broad-based, low-rate approach and to avoid tax incentives for residents investing offshore, we believe it desirable to pay particular attention to the potential for excess burden as a result of international tax policy design.

Policy Options for the Tax Treatment of Offshore Investment

6.111 Finding a balanced solution to taxing offshore income is difficult. The economic models used in this area do provide some key insights, but their application must be tempered by real-world considerations.

6.112 We are seeking a regime that:

- is sustainable, which means that it must be understood and accepted by the key stakeholders;
- minimises excess burdens from all sources; and
- complies with New Zealand's international obligations.

6.113 We set out below the various options that we wish to consider further. As always, submissions are invited to guide us in this process.

Foreign tax credits

6.114 Faced with the reality of tax treaty requirements to allow tax credits, we are considering two possible approaches:

Allow tax credits

6.115 The first approach is built around the principle that, notwithstanding the residence and see-saw principles, New Zealand will allow tax credits as required by its tax treaties. In addition, tax credits for offshore taxes should, generally, be provided with respect to income from non-tax treaty countries in much the same way as is allowed for tax treaty countries – otherwise, the New Zealand tax law would introduce a significant distortion between investment in tax treaty and non-tax treaty countries. Furthermore, the required availability of tax credits with respect to branch income under treaties supports the availability of underlying foreign tax credits through foreign company investments broadly to the same extent as required under current law. These principles broadly support retaining the status quo under current law as regards the extent and availability of foreign tax credits.

Risk-Free Return Method (RFRM approach)

6.116 This method, which is outlined in detail in Annex A, is designed to introduce a fundamentally different means of taxation of equity investments by reference to the risk-free return, rather than the underlying income earned in respect of the investment. The approach is viewed as achieving a more balanced overall approach to taxing different forms of equity investment. The natural corollary of this approach (rather than its purpose) is to deny all foreign tax credits. However, the risk-free rate itself will, in many cases, be below the actual return on investment achieved by the taxpayer. Even without an explicit allowance for foreign tax credits, the RFRM approach may well cause a lower tax impost than the current rules. This is a somewhat radical approach that needs to be considered further. In particular, we would need to examine in more detail the likely reaction of tax treaty partners to such a move, the incentives created as regards investing in debt and equity investments and the incentives created as regards investing offshore or in New Zealand.

The grey list

6.117 At this stage, the Review has the preliminary view that the current compromise in the taxation of offshore income of New Zealanders is not sound and that change is necessary.

6.118 The original rationale for the grey-list exemption is that the tax systems in these countries are sufficiently similar to New Zealand so that attributing income from grey-list entities to New Zealand residents would produce significant compliance costs for taxpayers but no real revenue for the Government (because New Zealand would allow tax credits for grey-list country taxes).

6.119 Although it achieves some simplification goals, we are concerned that, within the current framework, the grey list provides incentives for investment towards the high-tax grey-list countries and that this incentive is not in the national interest. We are also concerned that vehicles such as low-taxed United Kingdom unit trusts are being used for investment into non-grey-list countries, thereby undermining the rationale for the grey list.

6.120 At this stage, we would recommend repeal of the grey list. This recommendation would be made on the proviso that the repeal can be fitted within a revised and satisfactory regime for offshore investment. We would not recommend this change if the effect was to bring all investment within the scope of the current CFC and FIF regimes. We contemplate recommending a repeal of the narrow, seven-country grey list in the context of a shift to an international tax regime for outbound investment along the lines of one of the options raised below.

Scope of taxation of offshore investment

6.121 We outline two broad policy options, both of which should be considered in the context of a repeal of the grey list:

Modified CFC approach

- 6.122 This approach involves introduction of an active/passive distinction for taxation of foreign direct investment by New Zealand residents in companies resident outside of a designated list of low-tax/tax haven countries. For portfolio investments in foreign-listed companies and widely-held unit trusts, this approach adopts the RFRM method. We call this first policy option the Modified CFC Approach.
- 6.123 We will consider whether this option meets the objective of minimising excess burden from all sources. It would certainly address the business concern that the current approach is likely to encourage people and entities to leave New Zealand. What we need to test is its effect on the location of the investments of those who remain resident in New Zealand.

RFRM approach

- 6.124 This approach involves broad introduction of the RFRM method for foreign investment. Two versions of this approach are outlined – one involving its introduction solely for foreign investments; the other involving its introduction also in a domestic context.
- 6.125 Our objective here is to study regimes that might be simpler to comply with than the current regimes and, in particular, remove some of the apparent anomalies between the taxation of the onshore and offshore investments of residents.

Preliminary observations on RFRM in the cross-border context

- 6.126 We first make some general observations on the RFRM method. This is described in detail in Annex A. If applied to foreign investments formally, the method does not provide for foreign tax credits. It is an approach that, in principle, gains support from the broad-base, low-rate approach and the desire to achieve a measure of uniformity of tax. It is an approach that, relative to the status quo, can be expected to have the effect of increasing the New Zealand tax burden in relation to grey-list investments as compared to investments in the rest of the world. That change in relative taxation can be expected to produce some movement of investment flows towards lower-tax countries and away from high-tax countries. This change has the potential to enhance New Zealand's national welfare within the economic framework developed above.
- 6.127 It is desirable to get some sense of the nature of the burden that would be imposed if the RFRM method were to be introduced on foreign equity investments. The following table shows average dividend yield for a variety of markets.

Table 6.4 – Dividend Yields

<i>Country or Region</i>	<i>Dividend yield¹⁶⁰</i>
Australia	2.79%
Japan	0.73%
New Zealand	5.75%
United Kingdom	2.66%
United States of America	1.18%
Americas (North and South)	1.26%
European Union	2.28%
World Average	1.53%

- 6.128 Dividend yield is derived by calculating the total dividend amount for a sector and expressing it as a percentage of the total market value for the constituents of the sector. Thus, imposition of income tax on a risk-free return of, say, four percent for portfolio investors results in taxation of returns above the dividend yield in all markets except New Zealand, where the dividend yield is higher. Introduction of the RFRM approach can be viewed by persons not currently taxed on gains from their foreign share investments as the equivalent of a partial capital gains tax, or wealth tax. In addition, the effect of the RFRM approach is to eliminate the credit for foreign taxes withheld on dividends.
- 6.129 However, for persons currently subject to tax on gains – for example, New Zealand unit trusts holding foreign investments and persons holding non-grey-list FIF investments, the introduction of RFRM would be expected to result in an overall reduction in tax burden. For example, if expectations for total returns on equity investments were, say, 10-15 percent (as a result of risk premium), imposition of tax on income at a risk-free return of four percent would be (if expectations are, on average, fulfilled) a significant reduction in the New Zealand income tax impost relative to the current position.
- 6.130 For direct offshore investment by New Zealanders who would, under current law, be entitled to New Zealand tax credits for underlying foreign tax paid, the RFRM method may increase or reduce New Zealand tax liability relative to the status quo. The following examples demonstrate this.

¹⁶⁰ As at June 2001, source Datastream.

Example 6.4

Assume a more than 10 percent investment in a foreign grey-list company that is expected to earn a 10 percent before-tax return, with foreign tax then arising of 33 percent. The current grey-list treatment would produce an after-New Zealand tax return for a New Zealand company investor of 6.7 percent (New Zealand allows a deemed UFTC sufficient to eliminate the New Zealand FDWP).

RFRM would increase the New Zealand tax burden by imposing a 33 percent tax on the four percent risk-free rate (New Zealand tax of 1.32 percent). This reduces the New Zealand company's after-all taxes return to 5.38 percent. This arises because the foreign tax is sufficient to be credited in full and eliminate the New Zealand tax liability, but the credit is not available under the RFRM method.

RFRM would generally increase current New Zealand tax burdens with respect to foreign direct investments in grey-list countries by New Zealand companies. (However, we note that this example ignores the fact that the foreign tax credit is clawed back by the time it goes out of the New Zealand corporate. It assumes that the company is able to source required distributions to shareholders from other New Zealand tax-paid income.)

Example 6.5

Assume a direct (that is, more than 10 percent) investment in a foreign company expected to earn a 10 percent before-tax return, with foreign tax then arising at 10 percent. The current tax treatment would produce an after-tax return for a New Zealand company investor of 6.7 percent (New Zealand allows a credit for the 10 percent foreign tax and charges 23 percent tax liability). RFRM would reduce the New Zealand tax burden in this case by imposing New Zealand tax of 1.32 percent, leaving the New Zealand company investor with a 7.68 percent return after all taxes (10 percent before-tax return less one percent foreign tax less 1.32 percent New Zealand tax).

For a four percent risk-free rate and a 33 percent New Zealand tax rate, the New Zealand tax burden under RFRM and current rules is approximately the same for New Zealand corporate non-portfolio investors entitled to full foreign tax credits where the foreign tax is at a 20 percent rate. RFRM produces lower New Zealand tax where foreign tax is lower than 20 percent and greater New Zealand tax where foreign tax is above 20 percent.

This outcome will vary depending on the risk-free rate and New Zealand tax rate for any given year.

Option One: modified CFC approach; with RFRM for offshore-listed investments

6.131 This policy option is outlined in Table 6.5 below. We assume taxation of New Zealand domestic investment remains unchanged (although extended expansion of the RFRM method in the New Zealand environment could be contemplated, such as for passive tracking funds).

Table 6.5 – Modified CFC Approach; with RFRM for Offshore-Listed Investments

<i>Type of New Zealand investor</i>	<i>Type of Investment in Foreign Company</i>		
	Listed Offshore (or Retail Unit Trust)	Income Interest in CFC	Unlisted Offshore (but not an income interest in a CFC)
Individual and Company (listed or unlisted)	<p>If 30 percent or greater interest = as for income interest in CFC.</p> <p>If less than 30 percent interest = RFRM method (by reference to market value).</p>	<p>Branch equivalent method for:</p> <p>(i) passive category for jurisdictions other than the black list;</p> <p>(ii) all income from black-list jurisdictions.</p> <p>Active category from non-black list = taxed only on repatriation to New Zealand.</p>	<p>If 30 percent or greater interest = as for income interest in CFC.</p> <p>If less than 30 percent:</p> <p>(i) interest = current FIF for black list and for passive category in non-black list;</p> <p>(ii) for active category in non-black list = if 10 percent or greater, no tax until distribution;</p> <p>(iii) if less than 10 percent = RFRM by reference to shareholders' funds.</p>

6.132 The position as regards FDWP, tax credits, BETA accounts etc for the 'income interest in CFC' and 'unlisted offshore' categories (except in the latter case, if RFRM applied) would remain substantially similar to that applying to similar methodologies under current law.

6.133 This option introduces the RFRM method on foreign-listed investments and retail unit trusts. This is an attempt to bring balance to the taxation of offshore portfolio investments. The effect on investment choices between investing onshore and offshore will need to be carefully considered. The position as regards compliance with New Zealand's tax treaty obligations will also need to be considered. This change in the method of taxing offshore investment in listed companies/unit trusts, although based on a different rationale, would have the effect of denying credits in New Zealand for foreign withholding tax on foreign dividends. The likely response of tax treaty countries will need to be gauged before a final recommendation can be made.

6.134 As regards non-portfolio investment offshore by New Zealand residents, the modified CFC approach is largely based on the assumption that New Zealand should continue to grant foreign tax credits on a basis broadly equivalent to the current law (see the discussion of the modified CFC approach above).

6.135 The proposed active/passive distinction for non-black-list countries can largely be justified on the same grounds as for the grey list. For countries with tax rates and regimes roughly similar to those in New Zealand, the active business exemption would reduce what would otherwise be significant compliance costs without, as a general matter, significant revenue loss. Significant compliance costs arise in applying the branch equivalent regime because it requires recalculation of the income of the offshore activity under New Zealand tax principles. Generally, for New Zealand companies investing in countries with tax regimes similar to New Zealand's, the branch equivalent exercise will not result in any significant New Zealand tax liability as a result of tax credits available for tax paid in the foreign country. This approach results in considerable reduction in compliance costs relative to the current position for New Zealanders investing outside the grey list. There is also some comfort in the notion that the New Zealand imputation regime creates a powerful incentive for residents investing offshore to minimise foreign taxes and pay New Zealand taxes. This is because imputation credits are available only for New Zealand tax paid.

6.136 There is also an element in the thinking that underlies this approach that is driven by a desire to target the CFC and FIF regimes somewhat more narrowly at offshore investment that is designed to avoid New Zealand tax, consistent with the more standard practice adopted by other countries. Having regard to the principles we have suggested at paragraphs 104 to 108 above, the international competitiveness/excess burden issue can be analysed as follows:

- the excess burden is more likely to be significant in the context of offshore investment if New Zealand's tax rules are significantly more aggressive (in terms of earlier accrual/restricting tax credits) than a significant number of the countries with which New Zealand has its traditional economic ties. Our survey of comparative jurisdictions indicates that New Zealand's CFC and FIF rules are significantly harsher than all the key countries with which we would normally make comparisons;
- we address below the possibility of a special rule for taxation of non-New Zealand domiciles who move to New Zealand, with the benefit of that rule lasting for a period of six to eight years. Accordingly, given the possibility of a targeted solution, we do not address this class of people further;
- we do not place weight on retreating from the current laws so as to assist New Zealand being used as a regional headquarters for international investments by foreign multinational companies. The conduit rules reduce corporate level tax on CFC and FIF investments to zero for companies wholly owned by foreign investors (with a 15 percent NRWT on repatriation offshore where no New Zealand tax has been paid). This has not produced any noticeable increase in the use of New Zealand as a regional headquarters by foreign multinational companies (although it may have reduced the number of counterfactual migrations). We do believe that headquarters operations in New Zealand are important because they provide opportunities for top and mid-level management whose activities in New Zealand are important to New Zealand's national welfare. But there appear to be non-tax-

strategic/location reasons for foreign multinational companies not using New Zealand as a regional headquarters; and

- we are concerned by recent developments involving migration of New Zealand-resident companies out of New Zealand, and also the movement offshore of a significant number of New Zealand's wealthy individuals. We note that there are no doubt significant non-tax reasons for these movements; in particular, access to greater opportunities in larger centres. However, we believe it is important that New Zealand's tax laws generally and, in particular, the tax laws relating to offshore investment, do not operate as a barrier to New Zealand-owned companies and New Zealand's high net worth residents using New Zealand as a platform for international expansion. This is particularly important for companies where international expansion/investment is necessary for residents to exploit offshore trading markets to the maximum possible extent. (We note that another possible way to address this issue in part is the 'Tax Cap' option discussed below.)

6.137 For residents conducting active businesses in low-tax countries, adopting the active/passive distinction would mean that residents would have a significant tax advantage by investing in, or creating businesses in, tax havens/low-tax jurisdictions as compared to investing in New Zealand and bearing full New Zealand tax. Even if this advantage is reversed on repatriation of earnings to New Zealand, the timing advantage is significant as a commercial matter. New Zealand has no general interest in promoting investments through tax havens or low-tax jurisdictions at the expense of its own tax base. Therefore, full branch equivalent calculations would be required for investments in 'black-list' countries.

6.138 The key to the design of this regime is the criteria for distinguishing between active and passive income. Our aim is for a less complex regime for distinguishing between passive and active income than that applicable in other countries. This may well be achievable, given the scale of the New Zealand economy and a desire for narrower targeting of the active exemption to address excess burden issues.

6.139 If this modified CFC approach is to be adopted, consideration should be given to whether rules should be introduced to allocate expenses and disallow or defer deductions for expenses in New Zealand of a New Zealand group of companies that are attributable to offshore investments, or to take such expenses into account in calculating available foreign tax credits; or, alternatively, for an adjustment to be made in calculating the thin capitalisation restriction on interest. The concern is that the incentives to maximise New Zealand tax provided by the imputation regime may not be sufficient to prevent use of offshore investments to reduce a resident company's New Zealand tax liability on its New Zealand-sourced income.

Branch equivalent calculations/problems with minority interests in unlisted foreign companies

6.140 Where current accrual of income is required, we have suggested the branch equivalent regime for persons holding income interests (10 percent or more) in CFCs or persons

holding a 30 percent or greater interest. The concept is that these investors have the ability to require information necessary to undertake the calculation. We also note that the branch equivalent regime in this option is generally applying only to those investing in black-list jurisdictions or those deriving passive income offshore.

6.141 Possibly the most difficult design issue is identifying the regime that should apply to investments in minority interests in offshore entities (see Table 6.5 above, outlining Option One). We welcome submissions in this area.

Option Two: risk-free rate of return for offshore investments

Table 6.6 – Risk-Free Rate of Return for offshore investments

<i>Type of Investment</i>			
<i>Type of investor</i>	Listed and Unlisted Onshore	Listed Offshore	Unlisted Offshore
Individual	Existing tax treatment	RFRM (by reference to market value)	RFRM (by reference to a surrogate for market value; for example, shareholders' funds)
Unlisted Company	Existing tax treatment	RFRM (by reference to market value)	RFRM (by reference to a surrogate for market value; for example, shareholders' funds)
Listed	Existing tax treatment	RFRM (by reference to market value)	Either a version of modified CFC as per Option One, or RFRM by reference to a surrogate for market value; for example, shareholders' funds

Option Three: risk-free rate of return for all except domestic unlisted investments

Table 6.7 – Risk-Free Rate of Return for all except Domestic Unlisted Investments

<i>Type of Investment</i>				
<i>Type of Investor</i>	Listed Onshore	Listed Offshore	Unlisted Onshore	Unlisted Offshore
Individual	RFRM (by reference to market value)	RFRM (by reference to market value)	Existing tax treatment	RFRM (by reference to a surrogate for market value; for example, shareholders' funds)
Unlisted	As above	As above	Existing tax treatment	As above

Table 6.7 – Risk-Free Rate of Return for all except Domestic Unlisted Investments

<i>Type of Investment</i>				
Listed	As above	Exempt at the listed company level; or RFRM (by reference to market value)	As above	Either exempt at the listed company level (but targeted anti-tax haven rules); or RFRM (by reference to a surrogate to market value; for example, shareholders' funds)

Analysis of Options Two and Three

6.142 Options Two and Three opt for a more expansive application of RFRM than Option One (RFRM is outlined in more detail above in this chapter and in Annex A).

6.143 In Option Two, RFRM is applied generally to all offshore equity investments by all types of investors. RFRM is not, however, applied in the New Zealand domestic context.

6.144 Use of RFRM to the extent proposed in Option Two would be novel and untested in practice. We are not at a stage in our research where we are able to recommend adoption of the RFRM approach to this extent. A number of issues would need to be resolved satisfactorily before it could be proposed:

- the effect on investment flows as a result of differences in regimes for offshore investment (generally RFRM) and onshore investment (income taxed under current rules). The result of this is that, for all businesses with expected returns above the risk-free rate (that is, expected to earn a risk premium), a tax system of the type outlined in Option Two would systematically under-tax earnings from offshore investments relative to earnings from onshore investments. However, the elimination of credits for foreign taxes that may otherwise be required to be given under tax treaties is an important fact in determining the extent of any incentive created for New Zealand residents to invest offshore;
- the effect on investment flows if there were differences between New Zealand's taxation of debt investments (returns fully taxed) and equity investments (taxed at the risk-free rate);
- the impact on New Zealand's tax treaties - in particular, whether tax imposed on New Zealand companies under RFRM would be creditable under foreign tax laws where the New Zealand company had non-resident shareholders; and, in addition, whether this approach would jeopardise continuation of credits under foreign laws for New Zealand taxes paid by or attributed to non-resident investors in New Zealand;

- an accurate assessment of the impact on government revenue of introduction of the regime;
- transitional issues would need to be considered;
- the extent to which avoidance concerns in the case of unlisted investments could be overcome, in particular as regards a reliable measurement of a surrogate for value and as regards prevention of transformation of fully taxed income from labour into income from capital taxed only on the RFRM basis;
- to the extent international competitiveness/excess burden is a factor in the design of the regime, consideration as to whether RFRM reduces excess burden sufficiently, particularly where, under a regime with credits for foreign taxes, no New Zealand tax would be imposed; and
- the interaction with the conduit regime (which is designed to release New Zealand companies of tax liability in relation to FIFs and CFCs to the extent the New Zealand companies are foreign-owned).

6.145 In Option Three, RFRM is applied to both New Zealand-listed investments and all offshore investments. It is again a novel and untested approach. RFRM is not applied to unlisted investments in New Zealand, in part because of concerns as to the ability to prevent transformation of income from labour into income from capital (if RFRM was to be applied to income from capital).

6.146 Many of the issues that require resolution in relation to Option Two also exist in the context of Option Three. By bringing the RFRM approach into play for New Zealand-sourced income, there is the potential to produce greater uniformity of tax burden across investments. But significant potential remains for distortion around boundary lines that produce changes in treatment. Taken to its extreme conclusion, RFRM could be applied to all income from capital (replacing the accrual rules and making severe inroads into corporate income tax). By bringing RFRM into play for certain onshore investment income, Option Three also raises the question as to how RFRM and the imputation regime should inter-relate.

Conduit relief

6.147 The conduit relief regime relieves New Zealand resident companies from tax liability in respect of certain offshore income to the extent of ownership of the New Zealand resident company by non-residents. Regardless of the nature of the changes to the regime for taxation of New Zealand residents on offshore income, the conduit relief regime remains appropriate from the perspective of economic theory – consistent with the residence principle, it relieves non-residents' liability for New Zealand tax on foreign-sourced income. This theory includes, however, the question of how much of this relieved income can be efficiently taxed by virtue of foreign tax credits and rents. There is also an issue as to whether New Zealand-resident companies controlled by non-residents should be able to reduce their New Zealand tax liability on New Zealand-sourced income by making offshore investments, and there is a question as to

the extent to which current rules are effective in preventing this. The Review would welcome submissions on this point.

Australia and triangular issues

6.148 We welcome the Government's initiative to address with Australia the so-called 'triangular' taxation issues. These arise when New Zealand residents invest in Australian companies that, in turn, have New Zealand investments, or when Australian residents invest in New Zealand companies that, in turn, have Australian investments.

6.149 At this stage, the Review prefers to await the outcome of the bilateral discussions between New Zealand and Australia on this issue. The Review intends to consider the outcome of those discussions and make recommendations if it believes any unilateral steps are desirable from New Zealand's perspective.

Foreign trust rules

6.150 We have not yet considered the foreign trust rules.

Questions we'd like you to consider

- (a) If the RFRM method is adopted for unlisted investments, are shareholders' funds the best measure of opening value on which to calculate the return? What alternatives exist?
- (b) If the modified CFC method is adopted, is 30 percent the correct threshold for branch equivalent calculations?
- (c) To what extent should New Zealand residents be able to reduce their New Zealand tax liability on New Zealand-sourced income by making offshore investments?

Attracting High Net Worth Individuals to New Zealand: Exemption from Application of CFC/FIF Regimes for Non-Domiciles

6.151 New Zealand currently treats individuals as either residents or non-residents for tax purposes. In general, residents are taxed on their world-wide income; non-residents, on their New Zealand-sourced income. As a deliberate matter of policy, it is easy to acquire New Zealand residence but, once acquired, it is relatively hard to lose.

6.152 Submissions to the Review have identified that these rules can discourage migration of high-net worth and skilled individuals to New Zealand, since, once they become tax resident, their existing overseas investments will be subject to the foreign investment

fund (FIF) rules. We are advised that this issue prevents many individuals from immigrating. To the extent this occurs, New Zealand's tax rules do not enhance national welfare.

- 6.153 We are therefore considering an intermediate status between the current 'bright line' delineating residents and non-residents by use of a domicile rule similar to that used in the United Kingdom. Under such a rule, individuals who are New Zealand residents but not domiciled in New Zealand would be exempt from our FIF and CFC rules. This regime would apply to persons who had never been tax resident in New Zealand.
- 6.154 Domicile is a common law concept. Broadly speaking, an individual is domiciled in the country where they have their permanent home. An individual can have only one domicile at any given time. Domicile is a more enduring relationship with a country than nationality or residence. This means that a change of residence will not necessarily be accompanied by a change of domicile. Strong evidence must be provided that there is an intention to live there permanently or indefinitely. Living in another country for a long time, although an important factor, is not enough in itself to prove an individual has acquired a new domicile. An individual's domicile is normally the domicile of their father at the time of their birth, but can be changed to another country if the individual moves there and intends to reside there permanently.
- 6.155 In a New Zealand context, an individual who came to New Zealand to work for, say, two years would be a New Zealand resident but would not be domiciled in New Zealand because of their intention to leave after two years. Therefore, any gains from their non-New Zealand-sourced investments would not be taxed in New Zealand unless the income from these investments was remitted to New Zealand.
- 6.156 The Review considers that residents who spend many years in New Zealand may become less mobile and less sensitive to New Zealand's tax rules. Therefore, it may be appropriate for the exemption from the FIF and CFC rules for non-New Zealand-domiciled individuals to be restricted to a prescribed time period, say, six to eight years.

Attracting high-net worth individuals to New Zealand: a tax cap

- 6.157 The current New Zealand personal income tax scale is open-ended: each dollar of income over \$60,000 is taxed at 39 cents in the dollar. This means that, as income rises, the average tax rate also rises. At an income of \$60,000, the average personal income tax rate is 24 percent, while at \$120,000, it is 32 percent. Put another way, a person earning \$60,000 pays \$14,670 in income tax each year. If they spend 75% of their after-income tax earnings (which corresponds to a very high level of savings), they would also pay around \$4,250 in GST.

- 6.158 As these figures show, such people are making a substantial contribution to the welfare of New Zealanders: their taxes are likely to be much more than any plausible estimate of the level of government spending on them.
- 6.159 This is consistent with the ‘ability to pay’ principle we set out in Chapter One, *Frameworks*.
- 6.160 But is there a point beyond which is it reasonable to stop people contributing to government expenditure? Is \$1 million in income taxes ‘enough’ for someone earning \$2.6 million? That is, if someone earning \$2.6 million in one year increased their income to \$3 million the following year, should their tax bill remain at \$1 million or increase, as per the current tax scale, to \$1,156,000?
- 6.161 In the context of both attracting high-income non-residents who may be tempted to locate to New Zealand and retaining wealthy residents who are also increasingly mobile, there may be a case for introducing a tax cap. This would involve setting a cap where, after paying a set amount of taxation, individuals would not be assessed for any further taxation. This has the effect of lowering the effective tax rate on their assets and removes a possible barrier to these persons relocating to New Zealand.
- 6.162 The benefits of this scheme are derived from non-residents that would not be deterred from seeking temporary residence in New Zealand, and their corresponding contribution to the tax base. It is not possible to speculate on how many non-residents would view New Zealand as a favourable destination as a consequence of this proposal. The costs stem from those residents who are already over these thresholds and may have their tax liability reduced.
- 6.163 The threshold above which assets and income are effectively excluded needs to be set at a mark high enough to avoid giving a tax break to high-income New Zealanders. As high-income persons contribute substantially to the tax base, there could be serious revenue consequences if the mark were too low. Conversely, if set too high, the effectiveness as a tool in increasing the attractiveness of New Zealand to non-residents would be reduced.
- 6.164 The table below summarises taxpayers that have incomes over a proposed threshold of \$1 million in tax (\$2.6 million in income). Two scenarios are examined: one where imputation credits are refunded and one where they are not. For each scenario, the number of taxpayers who exceed the threshold is given, as well as the revenue cost if income over the threshold were exempted. The table is derived from 1999 tax return data.

Table 6.8 – Coverage and Cost of a Tax Cap

Current Tax Liability	Refunding Imputation Credits		Not Refunding Imputation Credits	
	<i>Number of Persons</i>	<i>Cost</i>	<i>Number of Persons</i>	<i>Cost</i>
Over \$1.0 million	58	\$50m	23	\$11m

- 6.165 The revenue gain from not refunding imputation credits is evident. Refunding imputation credits would not be a significant factor from a non-resident’s perspective, but does have significant revenue implications to the tax base and substantially increases the benefits of this proposal to residents. There are no likely benefits in refunding imputation credits, but there are high costs.
- 6.166 The tax-over-\$1 million scenario has a cost of \$11 million, if all non-dividend income streams are zero-rated or refunded. Would this small cost be offset by an increased number of non-residents locating to New Zealand through increased tax revenue and other economic benefits? Another benefit, although unquantifiable, stems from those who are currently resident and are not enticed overseas for tax reasons. Would this loss to the tax base from departures exceed \$11 million?
- 6.167 We recognise that the tax cap idea, while having merit, also raises difficult issues in terms of both design and perceived fairness, and we have not come to any conclusion on its desirability. In this context, we would appreciate submissions on the feasibility of introducing a tax cap.

Conclusion

- 6.168 There is much to commend the policy framework that has been said to underlie the current international tax regimes.
- 6.169 In the area of taxing non-residents, we consider that the most appropriate direction for reform may be in refining the current regimes to ensure that New Zealand is taxing non-residents only in circumstances where the economic incidence of such taxes is not shifted onto New Zealanders.
- 6.170 Developing a regime for taxing foreign-sourced income of residents that is sustainable and based on an appropriate framework has proved difficult for successive governments. We have suggested some possible ways forward. We see merit in attempting to design a suite of regimes for taxing foreign-sourced income that have at their core the risk-free rate of return methodology, and plan to pursue the feasibility of this approach further.

CHAPTER SEVEN

SAVINGS

This chapter deals with the taxation of savings. In broad terms, our preliminary views are that:

Changes to the tax treatment of savings are often called for to address New Zealand's perceived poor savings record. Measures of saving are quite imperfect, but it is not obvious that New Zealand has a savings problem requiring government intervention. While the future well-being of New Zealanders does depend on savings levels, the quality of savings is also very important.

Tax concessions would increase disposable incomes, increasing individuals' ability to save, but this would be at least partially offset if the Government were required to increase other taxes to maintain revenue levels. Empirical evidence suggests that the effect of concessions on saving levels is insignificant but that they have large effects on how people save.

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

Introduction

- 7.1 Tax is one of several factors that may influence people's savings decisions – both how much they will save and the form in which they will save.¹⁶¹ Saving typically involves the acquisition of financial assets and their close substitutes, such as housing and small businesses.
- 7.2 There has been considerable debate in recent years about whether New Zealand has a savings 'problem', in the form of either too little national savings or too little private savings.
- 7.3 There has also been considerable debate about the appropriate tax treatment of savings. Since 1988, the policy underpinning New Zealand's tax treatment of savings has been to maintain neutral treatment across the different forms of saving and to tax income from savings identically to other forms of income, such as business income. This is sometimes referred to as a 'TTE' regime, since savings are funded out of post-tax

¹⁶¹ By 'saving', we refer to all additions to a person's net worth.

income (the first T), returns on savings are taxed (the second T) and withdrawals of savings are tax-free (the E).

- 7.4 The TTE regime exposes savings to the full effects of an income tax regime, which has the effect of reducing returns to saving. To the extent that the amount people save is sensitive to after-tax rates of return, the tax treatment may result in less saving. However, the international evidence suggests savings do not respond much to modest changes in after-tax rates of return.
- 7.5 Tax is just one influence on savings decisions. Motivations for saving include providing for retirement, saving for a rainy day, preparing for a large purchase and leaving bequests. People's savings decisions are therefore affected by their level of current and expected future income, their age and family circumstances (where people in mid-life tend to save more, while young people and retirees tend to draw on expected later, or earlier, savings) and personal preferences.
- 7.6 Wider considerations also have a bearing on savings decisions, such as economic growth and government policies. For example, the level of state-funded pensions will influence people's views on how much they need to set aside themselves for their retirement.
- 7.7 The overall level of tax (the government's revenue requirements) will have a significant impact on the ability of individuals and businesses to save. Likewise, growth in national income will affect the level of saving. A tax system that biases investment away from more profitable (from a national standpoint) but more heavily-taxed investments will stunt national income and hence savings.
- 7.8 Finally in this context, the tax system can also affect after-tax returns to savers through the way we tax non-residents, as noted in Chapter Six, *International Tax: Taxing Income from Inbound and Offshore Investment*. Higher taxes on non-residents will generally result in higher before-tax returns to capital, raising after-tax returns to savers.

162

The 'Savings Problem'

- 7.9 Changes to the tax treatment of savings are often called for to address what some people regard as New Zealand's poor savings record. It is necessary to consider two issues to determine whether New Zealand in fact has a savings 'problem':
- it is necessary to first determine just how much New Zealanders actually save. We note in this context that the level of national savings, not private savings, is the relevant concept; and

¹⁶² Conversely, while lower taxes on non-residents will generally result in a lower cost of capital for New Zealand businesses, they will also result in lower after-tax returns to savings.

- it is also necessary to be explicit about why we care about the level of national savings.

How much does New Zealand save?

- 7.10 Existing measures of saving are imperfect and have wide margins of error. Existing aggregate data on New Zealand's saving record show different trends and levels. The usually quoted measure of household saving, from the Household Income and Outlay Accounts (HHIO) of the System of National Accounts, shows the saving rate to be low and falling. In contrast, the Household Economic Survey (HES) shows the household saving rate to be high and rising.
- 7.11 In measured saving, many items that are investment are counted as current expenditure, with the result that the true level of national savings is understated. The current estimate is that national savings (that is, aggregate saving by households, businesses and the government) are two percent of GDP. In fact, a true measure of saving that incorporated items such as investments in education and consumer durables would, in likelihood, show savings in excess of 20 percent of GDP. Further work is therefore needed before a more comprehensive picture of national saving can be obtained.
- 7.12 Aggregate estimates provide only limited insights about the saving behaviour of individual households. At any point in time, while some (typically mid-life) households will be saving, other (typically young and old) households will be 'dis-saving'. This means that, while we would expect a growing economy to have a positive saving rate, it is perfectly conceivable for a high-income country to have a zero household saving rate. While two economies might both have zero household saving rates, this may conceal large differences in the accumulated stock of savings. New data for New Zealand expected in 2001 will shed some light on this.

Why does the level of national savings matter?

- 7.13 The answer to this question is relatively obvious: the more New Zealanders save, the better off we will be as a nation in the future. It is worth emphasising, however, that our future well-being depends not only on how much we save, but also on the average rate of return we earn on our savings. We note in this context that New Zealand's comparatively lacklustre economic growth over the past two or three decades is attributable more to our earning a low average rate of return on investment than to a lack of investment.
- 7.14 The point is that the quality of saving is as important as the quantity. It is therefore important to ensure that the tax system does not induce households to invest their savings in poorer-performing assets. We return to this issue below.

Can Changing the Tax System Increase National Saving?

- 7.15 If New Zealand has a savings problem, it is because national savings, not private savings, are too low. It follows that we should focus on the impact of taxes on national savings, not private savings.
- 7.16 Obviously, measures that reduce the tax impost on income from savings will, by themselves, increase individuals' disposable incomes, increasing their ability to save. But this ignores the government's need to raise other taxes to make up for the loss in tax revenue. If the revenue is not made up by other taxes, national saving will almost certainly fall.¹⁶³
- 7.17 The empirical evidence on whether individuals, on average, increase the amounts they save in response to higher after-tax rates of return is at best mixed.¹⁶⁴ It is often argued that this evidence suggests that tax measures designed to increase savings will necessarily be relatively ineffective. This conclusion ignores, however, another way in which savings concessions can lead to higher savings – by effectively redistributing income from people who are less likely to save (typically, lower-income households) to people who are more likely to save (typically, higher-income households). To the extent that tax concessions lead to higher savings, it is more likely to be because of this redistributive effect.

Taxes and the Quality of Savings

- 7.18 There is considerable evidence that people's choices about how they save are very sensitive to tax considerations. We have already discussed (in Chapter Two, *Tax Bases*) the impact of the tax system on New Zealanders' incentive to invest their savings in their homes, and the extent to which they apparently respond to this incentive. Since pecuniary returns to housing are generally lower than returns to financial assets,¹⁶⁵ households end up less wealthy (that is, with lower savings) than if they invested less in housing.

¹⁶³ It is generally implausible to expect that each one-dollar reduction in tax revenue, delivered to taxpayers in the form of, say, a concession for savings, will in every case induce at least a dollar's worth of additional private saving. More often, individuals would spend at least part of the tax reduction on increased consumption.

¹⁶⁴ This reflects the offsetting effects of 'substitution' and 'income' effects of a reduction of taxes on saving. The higher return to saving increases the incentive to save (the substitution effect). But higher after-tax returns mean that the amount that must be saved to reach a particular saving target has declined, which means more can be spent today while still meeting saving goals (the income effect).

¹⁶⁵ This, of course, is not surprising, since part of the return to additional investment in owner-occupied housing takes the form of non-pecuniary consumption benefits.

7.19 The sensitivity of people’s patterns of savings to differences in tax treatment between different savings vehicles means considerable care should be taken in the design of any tax concessions. We address this issue below.

Future Policy Directions

Our preference: maintain a neutral regime for savings

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

7.21 In the context of a TTE regime, however, we note that the Risk-Free Return Method (RFRM)¹⁶⁶ for taxing certain forms of income from capital would affect the middle ‘T’, to the benefit of savers. In particular, the approach would:

- reduce the extent to which the interplay between inflation and current tax rules discourages saving. Even quite low rates of inflation can result in significant over-taxation of real returns to saving and hence of future compared to current consumption;¹⁶⁷ and
- lead to a more neutral treatment of different forms of saving. The proposed approach could, potentially, apply across a wide range of savings vehicles, such as New Zealand and offshore-listed equities, financial arrangements, superannuation funds and unit trusts, as well as owner-occupied housing. This would promote scarce savings being devoted to their highest-yielding uses.

7.22 Of course, taxing only the risk-free yield on net assets on an accrual basis is only one of the options explored in Chapter Two, *Tax Bases*. If it is inappropriate to apply such an approach across a broad range of investments, it may nonetheless be possible to apply it to selected savings vehicles. The range of vehicles covered would need to be as broad as possible, however, to minimise the impact of tax rules on the form in which taxpayers save.

7.23 If even the limited application of such an approach is not possible, our view is that no tax concessions should apply to savings. We note, however, that there are a number of disparities in the tax treatment of returns to savings under the current tax system. Chief among these are:

- as noted above, the current tax treatment of owner-occupied housing biases saving decisions. A separate, but related, distortion results from the non-deductibility of mortgage interest, which provides an incentive to ‘pay the mortgage off first’ before

¹⁶⁶ See Chapter Two, *Tax Bases*.

¹⁶⁷ See Example 1.4 in Chapter One, *Frameworks*.

undertaking other saving, leaving households holding undiversified portfolios for a considerable number of years¹⁶⁸; and

- disparities in the tax treatment of different, but closely substitutable, savings vehicles, such as superannuation funds and unit trusts.

Tax concessions for savings

- 7.24 Despite our views, governments may wish to introduce savings concessions. If so, the components of the tax regime could be rearranged to produce a variety of results. For example, an ETT regime (which applied to certain defined-benefit superannuation schemes prior to the late 1980s) is the equivalent of a consumption tax treatment of savings (where tax is paid only when funds are withdrawn). An ETT approach potentially collects the same amount of tax over time as the current TTE regime, but only if the tax rate at the time of contributions is the same as the rate applying when withdrawals are made.
- 7.25 It is difficult to design ‘good’ savings incentives. For example, it may seem sensible to target incentives at savings above some threshold amount, to better target the incentive at new savings. However, this might just encourage erratic savings behaviour, like saving only every second year.
- 7.26 The transition to new concessions could also involve significant fiscal costs. While the pre-1988 superannuation concessions, for example, involved a considerable revenue loss, the transition to a TTE regime also resulted in a substantial revenue loss by allowing (previously exempt) contributions to superannuation schemes to be withdrawn tax-free. An ETT approach to saving (with an up-front benefit from saving) is attractive to many, but would involve a large upfront revenue cost for uncertain gains.
- 7.27 A concession that would involve a lower initial fiscal cost, and therefore potentially ease transition, would be to apply a reduced tax rate on savings – the middle T of the TTE regime. This could be represented as a TtE regime. The table below illustrates, at a broad level, the design issues that would need to be addressed in more detail in designing such a concession.

168 However, as we explained in Chapter Two, *Tax Bases*, we do not advocate extending mortgage interest deductibility, particularly if the current treatment of owner-occupied housing is retained. Extending mortgage interest deductibility would likely result in increased over-investment in housing.

Table 7.1 – Design Issues Under a TtE Regime

<p>Need to limit fiscal costs; in particular, options for higher income taxpayers to shelter income</p>	<p>Limit the extent of investments by the taxpayer that would be subject to concessional tax treatment. Options include:</p> <ul style="list-style-type: none"> • Savings institutions administering a limitation. However, how would entities know what an individual taxpayer had invested among various institutions? • Taxpayers complying with limitations. This raises several issues, including the means by which individual taxpayers would keep track of the contributions entitled to any concession, and how they would advise institutions accordingly. Issues arise also in the administration of tax returns by the IRD; in particular, whether a wider range of taxpayers would be required to submit annual returns.
	<ul style="list-style-type: none"> • Providing that the concession would apply to only one (or a limited number) of ‘designated’ investments by a taxpayer. The concession could be limited to a maximum amount. If the investments were made through more than one institution, the taxpayer might be required to notify those institutions of the spread. The institutions, in turn, would need to be able to share information to comply with any maximum concession. <p>The last of the above options seems the most feasible, but still raises several design questions that would need to be explored further.</p>
<p>Target the incentive on new savings</p>	<p>Limit the transferability of any saving instrument (such as a superannuation policy) among individual taxpayers.</p>
<p>Limiting the concession to savings that are locked in</p>	<p>Limit access by the taxpayer to tax-preferred investments to a minimum period.</p>
<p>Ensuring that taxpayers are not locked in to particular savings institutions</p>	<p>Allowing institutions to offer investments where the taxpayer has the option, under commercial terms, to transfer the investment to another manager.</p>

ANNEX A

THE RISK-FREE RETURN METHOD

Introduction

A.1 This annex describes the rationale underpinning the risk-free return method (RFRM) described in Chapter Two, *Tax Bases*, examines its basic mechanics and notes some of the issues that would have to be resolved before the approach could be implemented.

What is the risk-free return method?

Basic mechanics

A.2 We explained in Chapter Two, *Tax Bases*, that the tax base under the RFRM is the amount that would have been earned if:

- the funds invested in an asset subject to the regime had instead been invested in a risk-free government bond; and
- the portion of the return on the bond that represented compensation for inflation was exempt from tax.

A.3 Application of the RFRM would in most instances be extremely straightforward. Tax payable on the return to an asset (say, shares in a New Zealand company) would be calculated simply as:

$$\begin{array}{r} \text{Asset's value at beginning of year} \\ \times \\ \text{Inflation-adjusted risk-free rate of return} \\ \times \\ \text{Investor's tax rate} \end{array}$$

Example A.1

Joe owns 100 shares in XYZ Co, a listed New Zealand company. At 1 April 2004, XYZ Co is trading at \$4.50. Also on 1 April, Inland Revenue publishes the risk-free rate of return that will be used to calculate tax liabilities for the coming year. For 2004, the rate is four percent. Joe's marginal tax rate is 39 percent.

Joe's taxable income for the year ending on 31 March 2005 in respect of XYZ Co is simply

$$100 \times \$4.50 \times 0.04 = \$18.$$

$$\text{Tax payable by Joe is } \$18 \times 0.39 = \$7.02.$$

Comparison of the RFRM and the conventional approach to taxing income from capital

A.4 This section compares the RFRM and the conventional approach to taxing income from capital. We base our comparison on the following scenario:

A.5 John has \$200 in investments. \$100 is invested in government stock yielding 6 percent and \$100 is invested in shares. There is a 50 percent probability that the return on the shares over the coming year will be 25 percent and a 50 percent probability that the return will be -5.0 percent, so the expected return is 10 percent. John's tax rate is 30 percent.

A.6 From Table A.1, John's potential after-tax return is \$21.70 if the shares perform well and 70 cents if they don't, for an expected (or average) net return of \$11.20.

Table A.1 – Initial Position

	Return on Govt stock	Return on Shares	Total before Tax	Tax	Net Return
Shares perform well	\$6.00	\$25.00	\$31.00	\$9.30	\$21.70
Shares do not perform well	\$6.00	-\$5.00	\$1.00	\$0.30	\$0.70
Expected Return	\$6.00	\$10.00	\$16.00	\$4.80	\$11.20

A.7 The government now introduces the RFRM. Under the RFRM, the opening value of John's shares is taxed at the risk-free rate of 6 percent, irrespective of how well the shares perform. If John does not adjust his portfolio, the change in tax treatment will affect his potential after-tax returns, as shown in Table A.2.

Table A.2 – Returns after RFRM introduced, before any portfolio adjustment

	Return on Govt stock	Return on Shares	Total before Tax	Tax	Net Return
Shares perform well	\$6.00	\$25.00	\$31.00	\$3.60	\$27.40
Shares do not perform well	\$6.00	-\$5.00	\$1.00	\$3.60	-\$2.60
Expected Return	\$6.00	\$10.00	\$16.00	\$3.60	\$12.40

A.8 In comparing Tables A.1 and A.2, we observe:

- the volatility, or riskiness, of John's portfolio has increased. When the shares do well, John is better off than he was previously. When they perform poorly, John is worse off. Overall, however, he is receiving compensation for this higher risk, since his expected after-tax return has increased from \$11.20 to \$12.40; and

- while John’s expected after-tax return has increased by \$1.20, the government’s expected tax revenue has decreased by this amount. Coupled with this decrease in revenue is a decrease in the volatility of the government’s revenue stream.

A.9 However, if John was comfortable with his exposure to risk before the tax system was reformed, it is reasonable to assume that on introduction of the RFRM he will adjust his portfolio in an attempt to recreate his pre-reform position. Suppose John sells \$30 of shares and purchases \$30 of government stock, so he now holds \$130 in government stock and \$70 in shares. Table A.3 shows his expected returns.

Table A.3 – Returns after RFRM introduced and after portfolio adjustment

	Return on Govt stock	Return on Shares	Total before Tax	Tax	Net Return
Shares perform well	\$8.00	\$18.00	\$25.00	\$3.60	\$21.70
Shares do not perform well	\$8.00	-\$4.00	\$4.00	\$3.60	\$0.70
Expected Return	\$8.00	\$7.00	\$15.00	\$3.60	\$11.20

A.10 After adjusting his portfolio, John is in exactly the same position he was in before the reform: both his expected after-tax return and his exposure to risk are exactly the same as they were previously.

A.11 So what’s really happening here? It is not coincidental that both John’s tax rate and the percentage of his shares he converted into government stock are 30 percent. Putting aside the inflation adjustment, the key difference between the conventional income tax and the RFRM is that under the conventional approach, the government is effectively a silent equity partner in an investment, whereas it is more like that of a debt investor under the RFRM.

A.12 In particular, under the conventional approach, the government shared 30 percent of John’s exposure to risk: if the shares performed well, the government gained 30 percent of the return; if they performed poorly, the government compensated John for 30 percent of his loss.¹

A.13 The other thing to note about Table A.3 is that, while post-reform portfolio adjustments have resulted in John being in the same position he was in before the change, the government’s position is still different. Whereas expected tax revenue was a risky \$4.80 pre-reform, it is now a more certain \$3.60.²

¹ We are abstracting in this section from numerous real-world features of the tax system, including restrictions on the use of tax losses.

² While tax revenue is considerably less volatile under the RFRM, the government is still exposed to the risk of the taxpayer defaulting; for example, on bankruptcy.

A.14 To complete the analysis, we need to note that, in the course of John’s portfolio changes, the government has (or could have) issued an additional \$30 in government stock, on which it is paying interest of 6 percent, or \$1.80. There is no obvious reason why the government would necessarily want to restore itself to exactly its pre-reform exposure to revenue volatility. But if it wanted to, it could do so by using the \$30 proceeds from selling government stock to purchase the shares that John no longer wants to hold. Table A.4 shows the government’s net revenue flows under this approach.

Table A.4 – Government’s revenue flows

	Tax Revenue	Interest on Government stock	Return on Shares	Net revenue
Shares perform well	\$3.60	–\$1.80	\$7.50	\$9.30
Shares do not perform well	\$3.60	–\$1.80	–\$1.50	\$0.30
Expected Revenue	\$3.60	–\$1.80	\$3.00	\$4.80

Rationale

A.15 The RFRM overcomes various problems with the current income tax system, while avoiding the problems associated with the taxation of capital gains on realisation. For example:

- under the RFRM, the tax system will not sway taxpayers’ decisions about whether to invest in ‘income’ or ‘growth’ shares since tax liabilities are independent of the extent to which returns to an asset comprise cash or capital growth;
- the RFRM is fair, in the sense that any two taxpayers with the same start-of-year wealth will face the same tax liability, irrespective of any differences in the types of asset they invest in;
- the RFRM provides a straightforward way of effectively indexing the tax system for inflation, simply by using an inflation-adjusted, rather than nominal, risk-free rate of return in the calculation; and
- there is no advantage under the RFRM to be had from recharacterising taxable income as capital gains.

Design Detail

Calculating the risk-free rate of return

A.16 A single risk-free rate of return would apply to all investments included in the regime. The rate would be calculated annually by Inland Revenue at (or toward) the beginning of an income year. The rate would be based on government debt with a one-year term to

maturity, adjusted for expected inflation over the coming year. The inflation adjustment means taxpayers would be taxed on the real (or inflation-adjusted) risk-free rate of return to their investments.

Example A.2

On 1 April 2004, the interest rate on government stock with a one-year term to maturity is 6.0 percent. The mean forecast of inflation (change in the CPI) by major forecasters for the coming year is 2.0 percent. \$1 held at the start of the year will have to increase in value to \$1.02 merely to maintain its initial purchasing power, while \$1 invested in government stock will increase in value to \$1.06.

The expected real rate of return on government stock over the next 12 months is therefore

$$\frac{1.06}{1.02} - 1 = 3.92\%$$

In practice, the uncertainty surrounding inflation forecasts is such that, for modest rates of inflation, the simpler approach of setting the real risk-free rate equal to the reported return less expected inflation (that is, 6% – 2% = 4 percent) would probably be sufficiently accurate.

Debt-financed assets

- A.17 No deductions would be allowed under the RFRM for interest or other expenses incurred in generating income from the asset. The rationale is simply that the imputed rate of return is intended to proxy a net return after allowing for all expenses.
- A.18 This treatment is not, however, adequate where a taxpayer has borrowed money to acquire a qualifying asset. In such cases it is appropriate to, in effect, apply RFRM treatment to the debt as well as the asset, with the net result being that the RFRM tax base for, say, an individual would be: (opening qualifying assets less opening qualifying debt) x risk-free rate of return.
- A.19 It would be necessary in this context to devise rules for the apportionment of debt between qualifying assets and other uses, which would in turn include the acquisition of ordinary income generating assets and non-taxable assets.
- A.20 We also note that issues addressed below and arising out of intra-year variation in taxpayers' holdings of qualifying assets would apply equally to intra-year changes in qualifying debt.

Part-year holding periods

- A.21 In practice, the amount a taxpayer has invested in, say, a listed company may vary over the course of a year. There are in principle at least two ways of dealing with part-year holding periods:

- one approach is to simply ignore intra-year transactions, basing the tax calculation on start-of-year investments and assuming the investment is held for the full year; and
- another approach is to amend the calculation to apply to part-year holding periods. Under this approach, a taxpayer who held shares in a company for 6 months during a year would pay tax on the opening value of the investment multiplied by 6 months worth of interest.

A.22 An argument against recognising part-year changes in investments is that the RFRM is intended to be a tax on anticipated (real) risk-free returns over the coming year, and that recognising realisations during the year is at odds with this principle. Further, recognising part-year changes in investment holdings may result in taxpayers making tax-driven investment decisions. Example A.3 illustrates.

Example A.3

Suppose the tax system recognises part-year realisations.

Part 1

By 30 September 2004, Joe's shares in XYZ Co have doubled in value to \$9 per share, or \$900 in aggregate. Joe would like to sell the shares and use the proceeds to purchase 900 \$1 shares in ABC Co. Since the tax system recognises part-year realisations, Joe's taxable income would be calculated as follows:

$$\text{XYZ Co: } \$450 \times 1.04^{183/365} = \$8.94$$

$$\text{ABC Co: } \$900 \times 1.04^{182/365} = \$17.77$$

$$\text{Total: } \$8.94 + \$17.77 = \$26.71.$$

If Joe does not realise his investment in ABC Co and purchase shares in XYZ Co (or if the tax system does not recognise part-year realisations), his taxable income for the year will be \$18, as in Example A.1.

Part 2

By 30 September 2004, Joe's shares in XYZ Co have halved in value to \$2.25 per share, or \$225 in aggregate. Joe is indifferent between holding shares in XYZ Co and ABC Co. If Joe switches from XYZ Co to ABC Co, his taxable income will be:

$$\text{XYZ Co: } \$450 \times 1.04^{183/365} = \$8.94$$

$$\text{ABC Co: } \$225 \times 1.04^{182/365} = \$4.44$$

$$\text{Total: } \$8.94 + \$4.44 = \$13.38$$

compared to \$18 if he held his XYZ Co shares until year-end.

A.23 Recognising part-year transactions clearly provides an incentive to hold onto profit-making investments and to realise loss-making investments. This is comparable to the 'lock in' effect under a realisation-based capital gains tax, as discussed in Chapter Two,

Tax Bases. However, ‘lock in’ under the RFRM is a lot more mild than under a capital gains tax, since the incentive to defer realising gains will only persist until year-end, when the investment’s opening value will be adjusted upward to reflect its higher value.

A.24 Example A.4 shows that the alternative approach, of simply taking start-of-year investments and assuming they are held for an entire year, will also not necessarily be appropriate in all circumstances.

Example A.4

Suppose taxable income under the RFRM scheme is calculated simply as the value of qualifying assets on the 1st day of the year times the real risk-free rate of return. Cash is not a qualifying asset.

Part 1

On 1 April 2004, Martha has \$1,000 in cash. On 2 April, Martha purchases 1000 \$1 shares in ABC Co and holds them for the balance of the year.

Since Martha did not hold any qualifying investments on 1 April, her RFRM taxable income for the year is nil.

Part 2

On 1 April 2004, Martha has \$1,000 \$1 shares in ABC Co. On 2 April, Martha sells the shares and spends the proceeds on a holiday.

Since Martha held \$1000 in qualifying investments on 1 April, her taxable RFRM income for the year is $\$1,000 \times 4 \text{ percent} = \40 .

A.25 We do not believe the issues raised in Examples A.3 and A.4 are insurmountable. Rather, they are illustrative of the types of practical design issues that would have to be resolved before an RFRM could be introduced. In part, they emphasise the need for a well thought out and comprehensive approach to dealing with portfolio changes, which may or may not involve changing the proportions of funds a taxpayer has invested in assets subject to the RFRM status and assets subject to other rules.

Qualifying assets

Application to traded assets

A.26 The RFRM can potentially be applied to any asset if a verifiable and independent estimate of the asset’s opening value is available each year. As noted in the text, the most obvious application of the regime is to equity investments by New Zealand resident individuals in listed companies, either in New Zealand or offshore. However,

the regime could be applied to a broader range of assets. One possibility discussed in Chapter Two, *Tax Bases*, is real estate, potentially including owner-occupied housing.

A.27 If the regime were to be introduced at all, there would be some obvious advantages to applying it to as wide a range of assets as is reasonably feasible. In particular:

- interfaces between different tax regimes inevitably result in both a more complex tax system and in unintended consequences, both favourable and unfavourable for taxpayers. It is therefore desirable to minimise the number of instances where a taxpayer has to move between regimes;
- applying the same regime to a wide range of assets makes it as clear as possible to taxpayers that tax effects are consistent across assets; and
- because the regime taxes income on a real, or inflation-adjusted basis, returns to assets within the regime will generally be taxed more favourably than returns to assets that fall outside. A broader regime will minimise the extent to which this discrepancy distorts decision making or results in inequities.

A.28 Apart from equity investments in listed companies, the regime could also be applied to any other financial instruments - such as debt, derivatives and hybrids - that could be marked to market either annually or on acquisition.

Application to non-traded assets

A.29 We have also put some thought into the potential application of the regime to non-traded assets, such as interests in unlisted companies. As we explain in Chapter Six, *International Tax: Taxing Income from Inbound and Offshore Investment*, there could be some advantages in applying RFRM to interests in unlisted companies that are currently subject to the Controlled Foreign Company (CFC) regime.

A.30 The key problem in applying the regime to an interest in a non-traded asset is obtaining a reasonable estimate of the start-of-year market value of the interest. In the absence of alternative sources of information, we see no choice other than to rely on accounting information, though there are some obvious difficulties with this approach. Among other things, these include:

- the less than perfect correlation between market values and book values;
- cross country differences in the content and enforcement of accounting standards;
- the potential, particularly in closely held situations, for the manipulation of accounting numbers;³ and
- difficulties in apportioning shareholders' funds in situations where a company has multiple classes of shares that have varying rights.

³ Suppose, for example, that equity but not debt interests in closely held companies were taxed under RFRM. It would be straightforward to reduce reported shareholders funds or net assets by injecting (possibly, low interest) related party debt. Off-balance sheet financing arrangements could also be used to manipulate reported results.

Interface with other regimes

A.31 The RFRM represents a departure from the current transactional-based approach to the taxation of returns to investment in New Zealand corporates. The dividend imputation regime relies on transactions (the payment of dividends or the issue of bonus shares) to prevent double taxation, once at the corporate level and again at the individual level. It would therefore be necessary under the RFRM to devise an alternative way of avoiding over taxing corporate income. Either of two approaches could be taken:

- company-level tax that was attributable to resident shareholders could be offset by way of a domestic investor tax credit (DITC), analogous to the foreign investor tax credit (FITC); or
- the imputation system could be retained, with credits attached to exempt dividends and available for offset against other taxable income of the investor. This means that an investor with little or no other income would not obtain the benefit of the imputation credit. We are therefore also considering whether imputation credits can be cashed out to domestic shareholders without infringing non-discrimination articles in our double taxation agreements.

A.32 Our initial view is that the first of these two approaches is superior. In particular, it results in the adjustment to tax payable occurring in the same entity as the initial payment. Among other things, this will mean any refund can be anticipated in paying provisional tax, avoiding adverse cash-flow effects, and we will not end up with situations where companies pays tax on behalf of shareholders who are unable to utilise the resulting imputation credits.

Scope of application

A.33 The RFRM is feasible for any investments that have an independently verifiable value, such as interests in listed companies and unit trusts. We do not, however, see that there is any advantage to applying the RFRM approach to investments by New Zealand companies into other New Zealand entities and therefore propose that existing rules continue to apply.

A.34 We consider in Chapter Six, *International Tax: Taxing Income from Inbound and Offshore Investment*, the potential scope of the regime's application to offshore investment by New Zealand resident individuals and entities.

A.35 We do not envisage the regime applying to investment by non-residents in New Zealand companies. In particular, we wish to retain the ability to levy withholding taxes on dividends paid to non-residents.

Withholding taxes

- A.36 An issue that we wish to explore further is the interface between the current withholding tax regimes and an RFRM. Recent changes mean that New Zealand resident individuals whose income is restricted to New Zealand-sourced wages, dividends or interest generally have the appropriate amount of tax withheld at source and therefore do not need to file tax returns. If possible, we would much prefer that this continued under an RFRM.
- A.37 The problem, however, is that the RFRM is not a transactions-based tax, and there will sometimes be instances where, say, dividends paid to shareholders fall short of an RFRM liability. In these cases, we see no alternative other than to require shareholders to make up the shortfall between tax payable and the amount of tax withheld by the company, which would in turn necessitate the filing of tax returns.
- A.38 A related point is that, even where tax withheld by a company equals the tax payable on a shareholder's gross RFRM liability, adjustments will be required if the shareholder also has qualifying debt. This situation, however, is directly equivalent to shareholders who borrow under current rules to acquire shares, and who therefore still need to file tax returns.

Liquidity

- A.39 Another implication of the regime not being transactional based is that, irrespective of its scope, situations would inevitably arise where the annual tax liability in respect of an asset exceeded the annual cash flow to the shareholder from the asset. At issue is whether taxpayers should be able to defer paying tax until a later year in such circumstances. While this is an issue that would need to be investigated were the RFRM to be explored further, we have formed some preliminary views.
- A.40 There is not a strong case for allowing widespread deferral of tax in any instance where there is a mismatch between a taxpayer's tax liability and cash flow. Instead, any deferral regime should be targeted at instances where genuine hardship would otherwise arise.
- A.41 Hardship will not arise where the asset concerned is readily marketable and is divisible. For example, where taxpayers hold shares in a listed company, taxpayers can if necessary realise a portion of their holding to satisfy their tax liability.
- A.42 However, if the regime is applied to assets that are not readily marketable or divisible, such as property (particularly owner-occupied property), situations would sometimes arise where paying tax as it accrued would cause genuine hardship. We consider it would be appropriate to develop rules that allowed for some deferral of tax in these circumstances if the RFRM were to be developed further.

A.43 In any instances where tax liabilities were deferred, an appropriate interest charge should be applied to the carried-forward tax liability. We note that the logic underlying the choice of a real risk-free rate for the core regime does not extend to interest rates on carried-forward tax liabilities; in essence, a deferred tax liability is a loan by the government to the taxpayer and should be on similar terms to any other loan to the taxpayer. In particular, the interest rate on deferred tax should reflect prevailing nominal interest rates and make due allowance for risk.

ANNEX B

INTERNATIONAL COMPARISONS

Introduction

B.1 The following is a brief summary of the corporate and personal tax regimes for Australia, the United Kingdom, Ireland and the United States of America.

Australia

Corporate taxation

- B.2 Resident companies are liable for tax on income from sources both within and outside Australia. A company is resident in Australia if it is incorporated in Australia or carries on business in Australia and either is managed and controlled in Australia or is controlled by shareholders who are Australian residents. Non-resident companies are liable for tax only on their Australian-source income.
- B.3 The corporate income tax rate is currently 34 percent, which will be reduced to 30 percent from 1 July 2001.
- B.4 To calculate taxable profit, the profit disclosed in the company's statutory accounts must be adjusted for tax purposes. As a general rule, costs are deductible if they are necessarily incurred in carrying on a business and are not of a capital nature. A deduction may be taken for depreciation. Interest payable by companies is generally deductible on an accruals basis. A company can carry its trading losses forward indefinitely for offset against future income, provided the company satisfies the 'continuity of ownership' or 'same business' test.
- B.5 There are new rules to be introduced with effect from 1 July 2002, giving groups the option to file a consolidated group tax return.
- B.6 Most fringe benefits provided by an employer to the employee are taxable to the employer at the rate of 48.5 percent.
- B.7 Employers are required to meet a prescribed level of superannuation support for their employees. The basic level of support is 8 percent, which will rise to 9 percent by the year ended 30 June 2003.

Capital gains

B.8 Australia has a comprehensive capital gains tax regime. However, it is not a separate tax from corporate income tax. Any net capital gain realised on the disposal of qualifying assets is assessed at the corporate income tax rate. Capital losses may be deducted against capital gains and carried forward indefinitely.

Individual taxation

B.9 Residents are taxed on their world-wide income and realised capital gains on world-wide assets, whilst non-residents pay tax only on Australian-sourced income and capital gains from the disposal of 'taxable Australian assets'. Individuals are tax residents if they reside in Australia. This includes persons whose domicile and permanent place of abode is in Australia and persons who have been in Australia for more than one half of the year unless their usual place of abode is outside Australia and they do not intend to reside in Australia.

B.10 An individual's net capital gains are included in their assessable income and taxed at their marginal rate of tax. Where assets have been held for at least 12 months, concessions may be available whereby only half the nominal gain will be assessable.

B.11 The marginal tax rates for resident individuals are:

Taxable Income (\$)	Marginal Tax Rates
Up to 6,000	0%
6,001 to 20,000	17%
20,001 to 50,000	30%
50,001 to 60,000	42%
Over 60,000	47%

B.12 In addition to these rates, a Medicare levy is payable by employees at a rate of 1.5 percent and an additional one percent is charged on high-income earners.

United Kingdom

Corporate taxation

B.13 UK resident companies are subject to corporation tax on world-wide profits. A company is resident if it is incorporated or managed and controlled in the UK. A non-resident company is subject to corporation tax, if it trades in the UK, on the profits attributable to its UK operations.

- B.14 The standard rate of corporation tax is 30 percent and applies equally to both resident and non-resident companies. A lower 'small companies' rate of 20 percent applies to the income of resident companies (other than certain closely held investment companies) whose profits do not exceed £300,000. Marginal relief is available to companies with profits between £300,000 and £1,500,000. A 10 percent rate applies to companies with taxable profits of up to £10,000. Marginal relief is available to companies with profits between £10,000 and £50,000. A tax credit is allowed for overseas tax paid on income and capital gains from a foreign source.
- B.15 To calculate taxable profits, the profit disclosed in the company's statutory accounts must be adjusted for tax purposes. Revenue, but not capital, costs incurred wholly and exclusively for trade purposes are generally deductible. Book depreciation is not allowable for tax purposes. Instead, tax depreciation (known as capital allowances) is given according to statutory rules, depending on the class of the asset. Goodwill, any loss arising on the sale of fixed assets and certain entertainment costs are not deductible for corporation tax purposes, but interest payable and receivable by companies on financial instruments is generally deductible/taxable on an accrued basis.
- B.16 Trading losses may be offset against any other profits of the same period, or carried back for one year if the trade was carried on in that earlier year. Any remaining losses may be carried forward without time limit, but only against income from the same trade.

Capital gains

- B.17 Chargeable capital gains are calculated by deducting cost together with an indexation allowance (an inflation adjustment) from sale proceeds. The resultant gain is taxed at the applicable corporation tax rate. Certain gains on business assets may be deferred ('rollover relief') if the proceeds are reinvested in specified types of assets within twelve months before, or three years after, the disposal. Capital losses can be carried forward against capital gains without time limit.
- B.18 Dividends received from resident companies are exempt from tax. Dividends paid by a UK resident company are deemed to be received by the shareholder with an associated 10 percent tax credit. Foreign dividends are taxable subject to any double tax relief.

Individual taxation

- B.19 UK income tax applies, in principle, to all UK source income, regardless of the tax status of the recipient, and to all overseas income of UK residents.
- B.20 UK legislation uses the terms 'resident' and 'ordinarily resident'. Individuals coming to the UK for a temporary purpose only (up to two years) are normally not regarded as resident unless they spend 183 days or more in the UK during a tax year. Where visits amount to three months or more in each of four consecutive years, an individual will be regarded as resident from the beginning of the fifth year, and from the beginning of the

first if the future pattern of visits was then apparent. 'Ordinary residence' denotes a degree of permanence and generally means 'habitual' residence. If it is clear at the outset that the individual will be living in the UK for a period of at least three years, ordinary resident status will be presumed. A further concept relevant to the tax liability of an individual is domicile. Domicile is a common law concept that relates to an individual's intention that a certain country is their permanent home.

B.21 For the year ending 5 April 2002, the following income tax rates will apply:

Taxable Income (£)	Marginal Tax Rates
Up to 1,880	10%
1,881 to 29,400	22%
Over 29,400	40%

B.22 The basic personal allowance deduction from total income is £4,535. This allowance is increased for individuals over the age of 65.

B.23 The rate of tax withheld on savings (interest) income is 20 percent.

B.24 Dividends are received net of tax at 10 percent. Individuals subject to tax at the lower or basic rate are liable to tax at 10 percent on dividend income and this liability is met by a credit for the tax withheld. Higher rate taxpayers pay tax on dividend income at 32.5 percent.

B.25 Every working individual aged between 16 and 65 (60 for women) must pay social security contributions (known as national insurance contributions or NIC), if gross income exceeds £87 per week for the year ending 5 April 2002, at a rate of 10 percent up to a maximum of £48.80 per week where weekly income is over £575 per week.

B.26 For the year ending 5 April 2002, capital gains made by individuals in excess of an annual exemption of £7,500 will be treated as the top proportion of income and are taxed at the individual's marginal rate of income tax on savings income.

Ireland

Corporate taxation

B.27 A resident company pays corporation tax on its profits (income plus chargeable gains, but generally excluding distributions received from other resident companies) wherever they arise. A company is resident in Ireland if it is centrally managed and controlled in Ireland.

- B.28 A non-resident company trading through an Irish branch or agency pays corporation tax on the profits connected with that branch or agency. If the non-resident company has no branch or agency in Ireland, it is liable for income tax on Irish-source income and for capital gains tax on certain Irish assets.
- B.29 The standard rate of corporation tax on trading income is 24 percent. This is set to reduce at a rate of four percent per annum to reach a rate of 12.5 percent as from 1 January 2003. A reduced rate of 10 percent is currently available for profits from a wide range of manufacturing activities and certain financial, shipping and service activities. The 10 percent rate is being phased out by 2010. The activities covered by this rate will be taxed at 12.5 percent. Passive (non-trading income such as rental income) is taxed at 25 percent.
- B.30 To calculate taxable profit, the profit disclosed in the company's statutory accounts must be adjusted for tax purposes. Costs are generally tax deductible if they are incurred wholly and exclusively for trade purposes and are not of a capital nature. 'Capital' for this purpose implies that a long-term or enduring benefit is obtained or that the expenditure is related to a capital asset.
- B.31 Any profit or loss on the sale of fixed assets is not taxable or deductible for corporation tax purposes. Goodwill is also a non-deductible expense. A company is normally entitled to deduct payments of interest (other than interest treated as a distribution), royalties and other annual payments made by it in computing its corporation tax liability.
- B.32 Book depreciation is not deductible. For tax purposes, plant and machinery is depreciated on a seven-year, straight-line basis. This regime applies to both new and second-hand plant and machinery. For the first six years, the annual depreciation will be 15 percent and in year seven it will be 10 percent of allowable cost. Vehicles are depreciated at the rate of 20 percent on a reducing balance basis. Private cars are depreciated based on a maximum allowable cost of IR £16,500 for new cars and IR £10,000 for second-hand cars. New industrial buildings and hotels are depreciated on a straight-line basis of four percent and 15 percent per annum respectively.
- B.33 Trading losses may be offset against total profits of the same accounting period. Any remaining loss may be offset against current year profits of other companies within an Irish tax group.
- B.34 The imputation regime that was in operation has now been replaced by a dividend withholding tax at a standard rate of 22 percent from 6 April 2000. This applies to all distributions from an Irish company.
- B.35 Employers have to pay social insurance contributions at a rate of 12 percent on each employee's remuneration up to IR £36,600 per annum. A lower rate of 8.5 percent is payable in respect of employees earning up to IR £14,560 per annum.

Capital gains

- B.36 Chargeable capital gains are calculated by deducting the initial costs associated with the purchase of the asset (these include purchase cost and incidental costs of purchase and sale) from sale proceeds. Capital losses can be carried forward against capital gains without time limit. The rate of corporation tax on capital gains is currently 20 percent, but a 40 percent rate applies to certain gains in relation to foreign life assurance policies and interests in certain offshore funds when the income of the fund is not distributed.
- B.37 The first IR £1,000 of net gains by an individual in any year is exempt from tax. Gains arising from the sale of a principal private residence are generally exempt. Capital losses, in so far as they cannot be offset against gains in the year in which they arise, may be carried forward indefinitely.

Individual taxation

- B.38 Exposure to Irish tax is determined by an individual's domicile, residence status and the source of income. An individual is normally regarded as domiciled in Ireland if they view Ireland as their natural home.
- B.39 An individual will be regarded as resident in Ireland for a tax year if they spend more than 183 days in Ireland during the tax year, or if in the current and preceding tax year they spend a minimum of 280 days in Ireland subject to spending a minimum of 30 days in Ireland each tax year. An individual may also elect to be treated as an Irish resident for the tax year.
- B.40 An individual is regarded as 'ordinarily resident' in Ireland for a tax year if they have been resident for each of the three preceding tax years. A person will cease to be ordinarily resident in Ireland at the end of the third consecutive year in which they are not resident. There is, however, provision to reduce the amount of employment income subject to Irish tax in cases of Irish resident individuals who exercise part of their employment abroad.
- B.41 An individual who is not resident but still ordinary resident in Ireland will be taxed as if they were resident in Ireland, that is on their world-wide income and capital gains. The exception to this is income derived from either a trade or employment where all of the duties are performed outside Ireland. Individuals domiciled and resident in Ireland are subject to Irish income tax on their world-wide income from all sources. Non-residents are taxed on their income and gains from Irish sources only.
- B.42 The income of married couples may be combined for tax purposes ('jointly assessed'). Alternatively, a married couple may elect to be taxed as single persons. The rates are as follows:

Taxable Income (£)	Marginal Tax Rates
Single/separate returns	
Up to 17,000	22%
17,000 upwards	44%
Joint returns – Dual income	
Up to 34,000	22%
34,000 upwards	44%
Joint returns – Single income	
Up to 28,000	22%
28,000 upwards	44%

- B.43 Social insurance contributions are payable by individuals (both employee and self-employed). Different classes of social insurance contribution are paid on different income sources. An employee's liability is 4.5 percent of remuneration up to IR £26,500 and this is withheld by the employer. The first IR £100 of weekly earnings is exempt.
- B.44 There are various exemptions and personal allowances available, the amounts of which depend upon factors such as marital status, age and number of children. For instance, a personal allowance of IR £4,700 is given for a single resident person (IR £9,400 for married residents jointly assessed). The allowance is given at the standard rate of tax.
- B.45 Expenses incurred wholly, exclusively and necessarily in the performance of the duties of employment are deductible (for example, business travel, protective clothing). Some annual payments (for example, those payments made under qualifying deeds of covenant), medical and dental expenses are also deductible. Relief for mortgage interest paid is available up to certain limits at the standard rate of income tax.

United States of America

Corporate taxation

- B.46 US resident entities are subject to tax on all world-wide income. The general corporate tax rate for residents is 35 percent. State taxes of three percent to 10 percent will, however, apply in some situations.
- B.47 Dividends received are taxable but they are to a certain extent deductible. If the dividend is an inter-company dividend, it is taxable and 70 percent deductible if less than a 20 percent interest is held in the distributing company. If the interest held in the distributing company is 20 percent or more, an inter-company dividend is 80 percent deductible. The dividend is 100 percent deductible if the dividend has been received

from a member of an affiliated group. Dividends are fully taxable to individual shareholders at their normal marginal rates.

- B.48 The US does not allow any credits for tax paid at the company level to be imputed to shareholders, but there is no domestic withholding tax on dividends paid.
- B.49 A group of related companies may file a consolidated income tax return. Grouping of losses is allowed but only in an affiliated group where that group provides a consolidated income tax return. An affiliated group is one with at least 80 percent commonly held interest. Gains and losses made through intra-group asset transfers maybe deferred if the transfer is made within a consolidated group. There are limitations on the ability of an entity to carry forward losses to the consolidated group.
- B.50 A share repurchase by an entity may be treated as a sale of stock (capital gain treatment) or as a distribution (dividend to the shareholder). Repurchased shares are retained by the company as treasury stock.
- B.51 Losses may be carried forward for 15 years but there are strict criteria to meet. There is a ‘dollar per year’ limitation based on the value of the entity and the amount of the carry forward loss. To use the losses, both the consolidated group and the individual purchased entity must have income. Losses may be transferred within a group provided the consolidation provisions are complied with.

Capital gains

- B.52 Capital gains are taxable in the US, but the capital gains tax is applied at a lower rate than the standard corporate tax rate. The rate is 28 percent for corporations, and a maximum of 20 percent for individuals if the asset has been held for 18 months. Some capital gains are exempt and there are rollover relief provisions for involuntary conversions and investments in qualifying small business corporations.
- B.53 Individuals are subject to capital gains taxes, although there are significant exemptions. For example, if an individual has owned and lived in a home for two years as a primary residence, only gains of more than US\$250,000 need to be included in the tax return (US\$500,000 for married couples filing joint returns). Capital losses may only be offset against capital gains.

Individual taxation

- B.54 The US allows deductions for expenditure incurred in deriving income from employment (“itemized deductions”). For example, the costs of education that improve skills in a current job, including tuition fees, books and transport costs, are deductible. Costs incurred in training for a change of career are not deductible.

B.55 Mortgage interest can be deducted on a “qualified home”, broadly the main home or a second home. There is also a complex series of deductions and tax credits for dependent children, college tuition fees and pension contributions.

B.56 Married couples may either file individual tax returns or a joint return.

B.57 There have been major changes in relation to individual taxation in the US stemming from the Economic Growth and Tax Relief Reconciliation Act of 2001, signed into law on June 7. This Act reduces individual income tax rates, repeals the estate tax, doubles the child tax credit, provides limited individual alternative minimum tax (AMT) relief, expands tax incentives for education and retirement saving, and provides limited tax relief for married couples.

B.58 The legislation replaces the current five-rate tax structure with six lower rates as follows:

Income (US\$)	Old rates	New Rates
0 – 12,000	15%	10%
12,001 – 45,200	15%	15%
45,201 – 109,250	28%	25%
109,251 – 166,500	31%	28%
166,501 – 297,350	36%	33%
297,351 +	39.6%	35%

B.59 The new 10 percent rate is retrospective to the start of 2001, with the other rate cuts being phased in over six years, beginning July 1, 2001. The rate cuts are fully effective in 2006, but all of the tax provisions in the Act expire after 2010. The legislation also gradually reduces the top estate and gift tax rates and increases the exemption amount and repeals the estate tax in 2010.

ANNEX C

OVERVIEW OF NEW ZEALAND TAXATION OF OFFSHORE INVESTMENT

Type of Entity	Direct/Branch/Foreign Partnership	CFC	FIF	Grey List CFC	Grey List Income Other Than CFC
<i>Application</i>	Direct investment or foreign partnership (not company within section OB 1 definition).	40% by New Zealand resident where no other person has an equal or higher percentage of ownership; greater than 50% control by five or fewer New Zealand residents. Income is attributed if person has 10% or more income interest.	Not in grey list and not CFC or less than 10% income interest in a CFC.	Company liable to tax in Australia, Canada, Germany, Japan, Norway, United Kingdom, United States.	Company liable to tax in Australia, Canada, Germany, Japan, Norway, United Kingdom, United States.
<i>Individual – New Zealand tax prior to repatriation</i>	New Zealand tax on income as per New Zealand tax principles. Credit for foreign tax paid with respect to branch income (no carry forward).	New Zealand tax on branch equivalent basis. Credit for non-New Zealand tax paid by CFC (including withholding on dividends derived by CFC). Credits quarantined by country; credits can be carried forward.	New Zealand tax on FIF income (four methods: comparative value; deemed rate of return; accounting profits; branch equivalent). No credit for underlying tax paid by FIF, unless use branch equivalent. FIF income is exempt if holdings less than \$50,000.	No New Zealand tax.	No New Zealand tax.
<i>Individual – use of tax losses</i>	Branch tax losses can be offset against other income of individual.	CFC losses quarantined to CFC income (and branch equivalent FIF income) from the same country.	FIF losses can be offset against FIF income (other than branch equivalent) and, where the FIF loss does not exceed prior years' FIF income, other non-FIF income.	No pass through of foreign company loss.	No pass through of foreign company loss.

ANNEX C
OVERVIEW OF NEW ZEALAND TAXATION OF OFFSHORE INVESTMENT – CONT'D

Type of Entity	Direct/Branch/Foreign Partnership	CFC	FIF	Grey List CFC	Grey List Income Other Than CFC
<i>Individual – New Zealand tax on repatriation</i>	No New Zealand tax on profit repatriation from branch (no dividend).	Income tax is applied. Credit is provided only for New Zealand tax already paid on attributed income and foreign withholding taxes paid on dividends.	Income tax is applied. Credits are provided for withholding taxes paid on dividends when branch equivalent or accounting profits methods used.	Income tax is applied. Credit for withholding taxes only.	Income tax is applied. Credit for withholding taxes only.
<i>Individual – New Zealand tax on sale of foreign investment</i>	Generally must effect by way of asset sale (depreciation recapture; section CD 1 (land sales); trading stock).	No special rules, only taxable if one of sections CD 3, CD 4 or GB 1(3) applies.	New Zealand tax on gain from sale (FIF loss if loss on sale) if deemed rate of return method (exception for certain individuals). NZ tax on change in value on unrealised basis if comparative value method. No special rules where branch equivalent method or accounting profits method (as for CFC).	No special rules, only taxable if one of sections CD 3, CD 4 or GB 1(3) applies.	No special rules, only taxable if one of sections CD 3, CD 4 or GB 1(3) applies.
<i>New Zealand company level – New Zealand tax prior to profit repatriation</i>	New Zealand tax on branch income (New Zealand tax principles). Credit for foreign tax paid with respect to branch income (no carry forward).	New Zealand tax on branch equivalent basis. Credit for non-New Zealand tax paid by CFC (underlying tax, including withholding on dividends derived by CFC).	New Zealand tax on FIF income (four methods: comparative value; deemed rate of return; accounting profits; branch equivalent).	No New Zealand tax.	No New Zealand tax.

ANNEX C
OVERVIEW OF NEW ZEALAND TAXATION OF OFFSHORE INVESTMENT – CONT'D

Type of Entity	Direct/Branch/Foreign Partnership	CFC	FIF	Grey List CFC	Grey List Income Other Than CFC
<i>New Zealand company level – use of tax losses</i>		Credits quarantined by country; credits can be carried forward. CFC losses quarantined to CFC income (and branch equivalent FIF income) from the same country.	No credit for underlying tax paid by FIF, unless use branch equivalent. FIF losses can be offset against FIF income (other than branch equivalent) and, where the FIF loss does not exceed prior years' FIF income, other non-FIF income of the New Zealand company.	No pass through of foreign company loss to New Zealand company.	No pass through of foreign company loss to New Zealand company.
<i>New Zealand company level – New Zealand tax on profit repatriation</i>	No New Zealand tax on profit repatriation from branch (no dividend).	FDWP on dividend repatriations (33%). Credit for foreign withholding tax. Credit for underlying foreign tax paid by CFC (requires 10% or greater interest). Credit for amounts in BETA (ie, New Zealand tax paid under CFC regime or FIF tax where branch equivalent or accounting profits method used), but only so long as New Zealand company satisfies 66% continuity of ownership test.	No FDWP unless the accounting profits or branch equivalent method is used. In this case, credits are allowed as for CFC (note 10% or greater requirement for credit for underlying foreign tax paid by FIF). Credits are also provided for withholding taxes paid on dividends when branch equivalent or accounting profits methods used.	Effectively no FDWP for repatriations (requires 10% or greater interest).	

ANNEX C
OVERVIEW OF NEW ZEALAND TAXATION OF OFFSHORE INVESTMENT – CONT'D

Type of Entity	Direct/Branch/Foreign Partnership	CFC	FIF	Grey List CFC	Grey List Income Other Than CFC
<i>New Zealand company level – New Zealand tax on sales of foreign investment</i>	Generally must effect by way of asset sale (depreciation recapture; section CD 1 (land sales); trading stock).	No special rules, only taxable if one of sections CD 3, CD 4 or GB 1(3) applies.	New Zealand tax on gain from sale (FIF loss if loss on sale) if deemed rate of return method (exception for certain individuals). New Zealand tax on change in value on unrealised basis if comparative value method. No special rules where branch equivalent method or accounting profits method (as for CFC).	No special rules, only taxable if one of sections CD 3, CD 4 or GB 1(3) applies.	No special rules, only taxable if one of sections CD 3, CD 4 or GB 1(3) applies.

Shareholder Level

Dividend distribution by a New Zealand company is taxable to a New Zealand investor in each case. Credit is only allowed to the New Zealand resident investor for attached imputation credits or for FDWP credits; that is, credit is only allowed for NZ tax paid, and not for foreign tax taken into account in reducing CFC/FIF liability or FWDP liability.

(Credit may even be denied for New Zealand tax paid. This is because imputation credits and FDWP credits and FWDP credits are eliminated if the New Zealand company does not satisfy a 66 percent continuity of ownership requirement.)

Conduit tax relief rules

In broad terms, the conduit rules reduce the tax payable by a New Zealand resident company (corporate tax or FDWP) on its foreign-sourced income (excluding foreign branch income) in proportion to its non-resident shareholders.

The conduit relief mechanism operates at two different points in time. Relief is given to a New Zealand resident company when it derives both foreign attributed income or a foreign-sourced dividend (conduit income). When the New Zealand company distributes conduit income by way of dividend, NRWT of 15 percent is imposed.

ANNEX C

OVERVIEW OF NEW ZEALAND TAXATION OF OFFSHORE INVESTMENT – CONT'D

Conduit tax relief rules – cont'd

Ultimately, the amount of conduit relief is determined when a company distributes conduit income to its shareholders. In determining the amount of relief to be given when conduit income is derived, the percentage of non-resident shareholders of a company at that time is used as a proxy for the percentage of shareholders that will exist on distribution. If the percentage of shareholding changes, the credit allocation mechanism washes out the effect of the shareholding changes.

Interest allocation rules ensure that companies cannot allocate an excessive amount of debt to their New Zealand operations relative to CFCs and FIFs in which they hold interests, thereby generating an excessive amount of conduit relief. There is an incentive for resident companies to do this because the tax rate on New Zealand income is 33 percent, whereas the tax rate on conduit income is 15 percent. The fundamental test under the interest allocation rules is whether the New Zealand assets of a group are excessively debt funded relative to the assets of its CFC and FIF interests.

Two safe harbours ensure these rules apply only to groups that have high levels of debt in New Zealand and when a substantial amount of conduit relief is involved. The rules do not apply when:

- the debt percentage of a taxpayer's New Zealand group, as defined under the interest allocation rules, is less than 66 percent; or
- a taxpayer and all companies associated with the taxpayer are entitled to conduit relief for an income year of less than \$50,000.

ANNEX D

IMPLEMENTING A TARGETED REDUCTION IN THE COMPANY TAX RATE FOR NON-RESIDENT INVESTORS

D.1 This annex outlines a possible approach to implementing a reduction in the company tax rate that is targeted at non-resident investors. The approach is somewhat complex, but we believe achievable in practice. If after considering submissions we decide to pursue this approach, we will construct a more detailed set of workable proposals as part of Stage Two of the Tax Review envisaged in our terms of reference. While we assume for illustrative purposes that the reduced rate is 15 percent, we have not yet formed a view on an appropriate rate. We assume the current corporate tax rate of 33 percent for purposes of illustration.

The Regime

D.2 New Zealand-owned companies: the tax rate for companies owned solely by New Zealand residents throughout the year would be 33 percent.

D.3 Foreign-owned companies: the tax rate for companies owned solely by non-residents throughout the year would be 15 percent.

D.4 Mixed ownership: provided that the conditions in (4) are satisfied, where a company was partly owned by non-residents and partly owned by residents during a year:

- the company would measure percentage resident and non-resident ownership at the end of each quarter in the year and average the results, producing an average “resident percentage ownership” and a “non-resident percentage ownership” for the year; and
- the company’s tax liability would be its “taxable income times general corporate tax rate times the ‘resident percentage ownership’” plus “taxable income times 15 percent times the ‘non-resident percentage ownership’”.

D.5 For example, suppose the general corporate tax rate is 30 percent and consider a company that is 60 percent owned by non-residents and has taxable income of \$1,000. Its tax liability would be $(\$1,000 \times 40\% \times 30\%)$ plus $(\$1,000 \times 60\% \times 15\%)$, or \$120 plus \$90 equals \$210, giving an overall effective rate of 22 percent.

- D.6 Prerequisite for mixed ownership company qualifying for low rate: the prerequisites for application of the rule in (3) would be that within six months of the end of the relevant income year:
- the company would distribute to non-residents only (including a special holding company), by way of supplementary dividend, an amount equal to the tax saving for foreign equity investors; that is, the difference between the taxable income attributable to foreign investors taxed at the standard corporate rate and that amount taxed at 15 percent; or
 - the company would issue to non-residents only (including a special holding company), by way of non-pro rata non-taxable bonus issue, shares having a value equal to the tax saving for foreign equity investors.
- D.7 These requirements would be designed to confine the economic benefit of the tax rate cut to the non-resident investors intended to receive it.
- D.8 Who is resident/non-resident? For the purposes of these rules:
- a New Zealand resident shareholder company owning shares in another New Zealand company would be deemed to be a New Zealand resident shareholder for purposes of determining the New Zealand company's tax liability (even if the New Zealand resident shareholder itself has foreign shareholders), unless it is a special holding company (see below);
 - a special holding company would be a New Zealand resident company owned 100 percent directly or indirectly by non-residents throughout the year; and
 - a non-New Zealand resident company would be treated as resident if it is controlled by/significantly owned by New Zealand residents.
- D.9 Distributions: distributions/bonus issues to a special holding company would not be taxable for New Zealand tax purposes. We have not yet formed an opinion regarding the interaction of the AIL, NRWT and FITC rules for equity under our recommended approach. We are considering two regimes for distributions: retaining the FITC regime for portfolio investors and moving to the AIL/NRWT regime for non-portfolio investors.
- D.10 Sales of shares between Calculation Dates and Bonus Issue/Dividend Dates: we are also considering mechanisms to deal with non-residents who sell their shares between the time they are counted as non-residents for purposes of measuring ownership and the time the distribution is paid/bonus shares are issued.
- D.11 We are also considering one other mechanism. This would require New Zealand companies to pay the general corporate tax rate at all times. However, foreign-owned companies would be eligible to enter into a special holding company regime where, so long as the New Zealand company has paid New Zealand tax on earnings attributable economically to the special holding company, the special holding company receives a tax refund to reduce the net tax paid on taxable income ultimately accruing to the overseas owners.

Questions We'd Like You to Consider

- What are the practical implications of the possible regime outlined above?
- What technical approaches could be adopted to achieve the policy outcome of reducing taxes on non-residents?

ANNEX E

ENVIRONMENTAL EXTERNALITY ESTIMATES IN ROAD TRANSPORT

- E.1 To assist its evaluation of the 21c/litre general revenue petrol excise on petrol, the Review referred to the Ministry of Transport, *Land Transport Pricing Study*, which contains (preferred) estimates of environmental costs of \$990 million associated with the road transport network in the areas of water quality (\$100 million), noise pollution (\$290 million), and air quality (\$700 million).⁴
- E.2 As previously noted, this study concluded that:
- E.3 *It is not possible at this stage to reach firm conclusions about the level of environmental externalities that should be faced by transport users and whether pricing is an appropriate internalisation mechanism. A further difficulty with any general pricing regime is that transport pollutants are often very site specific.*⁵
- E.4 The view that road transport externalities in New Zealand are highly localised accords with views expressed elsewhere by the Ministry that "...vehicle emissions do not cause regional or urban wide air pollution levels of concern in New Zealand cities"⁶ but rather that "...New Zealand's air quality problems caused by vehicle emissions are very localised. There are currently no urban wide guideline exceedences caused by vehicle emissions but there are Guideline exceedences at particular locations in high use urban corridors."⁷
- E.5 The Review also notes that the appropriateness of petrol (or potential diesel) excises in addressing environmental externalities must be assessed in view of the application of such excises nation-wide.⁸

4 A figure of \$290 million was also postulated for greenhouse gas emissions but these will fall under whatever carbon tax or carbon trading arrangements are put in place as part of New Zealand's response to the Kyoto Protocol.

5 Ministry of Transport, *Land Transport Pricing Study: Full Report, Environmental Externalities*, p xxiv.

6 Ministry of Transport, July 1999, *Vehicle Fleet Emissions Control Strategy, Summary of Submissions*, p 1.

7 *Op cit*, p 24.

8 Note, however, that Regional Councils can levy local taxes on petrol sales. Wellington Regional Council levied such a tax in the period 1993-96.

Water quality

E.6 The study's water quality estimate was not based on willingness to pay since, as it notes, concern over water quality impacts was limited to, and accommodated by, specific road design situations. Instead, it was based on the estimated annual cost of installing "*almost full mitigation of effects over the entire roading network*". It would not seem unreasonable to expect that mitigation will occur as and where it is cost-justified and that its costs will be met by road users (through existing road charging mechanisms).

Noise

E.7 With respect to the valuation of noise and air quality, the study notes that a hedonic pricing study commissioned by Transit New Zealand covering "*...an Auckland suburb of relatively homogeneous owner/occupier housing with few obviously confounding features but with a range of road traffic exposure ranging from urban arterials carrying 20,000 vehicles/day down to no exit residential streets*"⁹ was unable to detect any statistically significant difference in house resale values according to traffic volume.

E.8 The Land Transport Pricing Study therefore based its preferred noise cost estimate of \$290 million on the application of overseas noise depreciation indexes to New Zealand residential property value data. Forty three percent of the \$1.85 billion depreciation in property values estimated by this approach was attributed to Auckland and a further 21 percent to Wellington and Christchurch.

Air quality

E.9 Of the \$700 million estimate for air quality, \$640 million was attributed to general urban-wide population exposure to background fine particulate matter, with almost all the remainder attributed to excess particulate exposure adjoining main traffic routes.¹⁰

E.10 The study qualifies its estimate of \$700 million by noting that:

E.11 It is evident that it is the wide area exposure which dominates the health damages estimates. This critically depends on the urban background levels of (fine particulate matter) the percentage attributable to road transport and the unit risk factors. For the first two of these the data is very tentative, while for the unit risk factor, the recommended value used here is much higher than that used by the EPA (Environmental Protection Authority, Victoria).

⁹ Ministry of Transport, *Land Transport Pricing Study: Full Report, Environmental Externalities*, p 33.

¹⁰ The background urban-wide concentration assumed (ranging from 6-30µg/m³ across high and low wind days) can be compared to the New Zealand Air Quality Guideline of 120µg/m³. Additional concentrations of 5µg/m³ were assumed adjacent to main traffic routes. At the Auckland (Mt Eden road) air quality monitoring site (average daily traffic 17,550 vehicles) referred to in the study, fine particulate matter and the six other pollutants monitored showed nil hourly Air Quality Guideline exceedences per annum. Moreover particulate concentrations at the Mt Eden road site did not exceed the background levels normally assumed for urban areas unaffected by specific sources (*ibid* p 60).

- E.12 The study further qualifies its air quality cost estimate by noting that the unit risk factor it uses is over six times higher than that reported (for petrol) by a wide-ranging literature review.¹¹ Similarly, while noting that:
- E.13 For the excess mortality from particulates exposure, the cost has been based on the value of a statistical life of \$2 million (1990 \$) used by the Land Transport Safety Authority and Transit New Zealand assuming a 70 year nominal lifespan.¹²
- E.14 The study also notes that in the study (of six US cities) from which its risk factor is derived "*the (excess) deaths are associated with people who have existing heart and lung disease, especially the elderly.*"¹³

11 Ministry of Transport, *Land Transport Pricing Study: Full Report, Environmental Externalities*, p 160.

12 *Op cit*, p 65.

13 *Op cit*, p 159.

ANNEX F

SUMMARY OF SUBMISSIONS

Introduction

F.1 The submissions raised both issues that submitters thought the Tax Review should consider and approaches to resolving issues. The following outlines some of the key themes, suggested solutions and approaches to the issues. On most issues there was a broad cross section of views expressing alternative and often opposing approaches.

Important to think about New Zealand in a Global Context

F.2 A number of submissions raised the idea that the Tax Review should be thinking about the New Zealand tax system in the context of the global environment. Some of the points raised include: the international mobility of capital and labour (especially skilled labour); the need to maintain international competitiveness; and that our tax rates are not high relative to some other countries.

Societal issues

F.3 A number of submissions raised the issue of equity and fairness in society more generally and the need for the tax system to support these principles. Some of these submitters also raised the need to consider the tax system and the welfare system concurrently. Another strong theme in the submissions was the issue of protecting the environment and the best way to do this. In addition, some submissions raised social justice and democracy as being linked to the tax system.

Complexity and compliance costs

F.4 There was a general consensus that any proposed changes should reduce complexity and compliance costs, especially for small businesses. Some of the suggested ideas included flatter tax rates, reducing the number of fringe benefit tax rates, increasing the value of assets that have to be capitalised, reducing the number of tax types, extending the use of the Generic Tax Policy Process, amongst others.

Tax rates

- F.5 The submissions on tax rates were either supportive of lower rates overall, a flatter structure or increased progressivity. For example, businesses argued for lower personal tax rates to ensure they could attract and retain skilled labour in a global market. Moreover, a number of submitters highlighted the need for further redistribution and the possibility of using more progressive tax rates to achieve this. Some submitters also emphasised the issue of increasing redistribution by introducing a tax-free threshold to assist low-income people. Other submitters raised the need to inflation adjust the thresholds for the various tax rates.
- F.6 A number of submitters raised the issue that there were ways around the high personal tax rate. One example given was the ability to take advantage of the corporate tax rate being lower than the top personal tax rate.
- F.7 A number of submissions also emphasised the high effective marginal tax rates facing some people. The focus of the concern was for those moving from the benefit to work, and those in low paid jobs trying to improve their circumstances.

Impact of tax on decision making

- F.8 There was a theme in some of the submissions that the tax rules should not influence decisions in the business and savings sectors. For example, one savings vehicle should not be preferred to another on the basis of the tax rules.
- F.9 In contrast, there were a number of submissions suggesting the use of incentives to encourage behaviour and influence decision making. For example, New Zealand has a low level of savings, so there should be an incentive to encourage savings. The submissions raised the use of incentives in the business area, savings, and the environment, amongst others. Concerns were raised that if incentives were introduced, then they would lead to poor economic decisions, and lobbying for further incentives.

Review the international tax regime

- F.10 A number of submissions commented on the complicated nature of the international tax regime in New Zealand. Submitters commented on the Grey list, Double Tax Agreements, taxation of foreign-sourced income, taxation of foreigners in New Zealand, triangular tax issues, Controlled Foreign Company regime, Foreign Investment Fund regime and the Foreign Dividend Withholding Payment regime.

GST

- F.11 GST was raised by a number of submitters. Issues raised include amongst others: removing GST on basic items such as food; removing GST on grants; GST on financial

services; GST on imported services; the benefit of one rate of GST; that GST impacts disproportionately on low income people; allocating GST on books to create a fund to give authors a minimum wage; and replacing GST with a financial transaction tax.

Tax unit

F.12 Submitters commented on the use of the individual or the family unit as the taxable unit. There were those supporting the status quo and those suggesting change. Issues raised included the tax disadvantage to single earner families compared with two income families with the same total income, the costs of children, and female participation in the labour market.

Universal income

F.13 Some submissions raised the issue of introducing a universal income for all (including a scaled amount for children). This was argued on the basis of recognising unpaid work in the home or community so that those with children are not disadvantaged compared to those without children, that it would be simpler to administer than the current benefit system, and that it would allow those not in employment to pursue other activities.

Capital gains tax

F.14 Submitters generally suggested that New Zealand does not require a generalised capital gains tax. There were a few exceptions. Submissions raised concerns with the ability to design a practical and simple capital gains tax that did not have problems with 'lock in' of assets and double taxation of entrepreneurship; that would not provide opportunities for taxpayers to reduce their tax by realising capital losses; and would not involve high compliance costs.

F.15 Submitters noted that the capital gains on a number of assets are already taxed and that not having a generalised capital gains tax in New Zealand is a competitive advantage.

Wealth tax

F.16 Submissions either supported or opposed a wealth tax. Those advocating wealth taxes raised concern about the ability of people to avoid income tax by receiving capital transfers and that asset rich but income poor groups may not contribute a fair share towards government revenue with the incidence of current taxation falling disproportionately on wage and salary earners. Those against a wealth tax raised concerns with the ability to design a neutral wealth tax that does not distort the composition of asset holdings, with the lack of information about wealth holdings in New Zealand and that overseas evidence suggests that wealth taxes raise little revenue.

Eco-axes

F.17 Submissions supporting and opposing eco-taxes were approximately even. A key theme was that eco-taxes should only be used for achieving environmental and not revenue goals. Submitters emphasised the benefits of reducing ‘bads’ and encouraging green behavioural patterns, the double dividend argument of lowering other taxes to increase employment and encourage better allocation of resources, the possible unintended consequences of an eco-tax and some of the difficulties in designing an eco-tax.

Carbon Taxes

F.18 Submissions for and against carbon taxes were approximately even and, in general, continued the tone of the submissions on eco-taxes. Specific points concentrated on the dire consequences of not reducing emissions; the ease of administering such a tax; the uncertainty behind the global warming science; the futility of trying to reduce New Zealand’s emissions in the context of reducing global emissions; and the high cost to New Zealand’s economy, international competitiveness and specific communities and industries. Several submissions raised the need for an in-depth review of the issue (outside of the Tax Review).

Excises

Tobacco

F.19 Submitters raised the issue of the level of the tobacco excise and the adverse impact of smoking on smokers and people around smokers (passive smokers). Two main ideas raised by submissions were to:

- increase the level of the excise on tobacco on the basis of the relative price responsiveness of the low-income and young smokers, and that higher prices prevent some children and adolescents from starting; or
- determine tobacco taxation in the context of an overall goal of social equity and community well-being.

F.20 Submitters also requested that some of the tobacco excise be set aside for an effective tobacco control programme to help smokers quit. In addition, submitters noted that increasing tobacco excises would impact negatively on low-income families and asked that the duty-free status of tobacco be removed. The key themes therefore were to increase the excise to encourage people to quit and to use some of the excise to provide programmes to help people quit.

Alcohol

F.21 Submitters raised the inconsistency in the level of the excise on wine and beer relative to spirits. Some submitters suggested addressing this by raising the excise on beer and wine, while others suggested addressing this by lowering the excise on spirits. Submitters also raised the desire to increase the excise to reduce social problems associated with consumption.

Gaming

F.22 In late May, a large number of the submissions were referred to the Tax Review by the Gaming Review for consideration. The Tax Review is still working through these submissions. Of the submissions received by the due date for submissions, the following views were put forward: all forms of gaming should be treated equally (for example, casinos and racing); the income exemption for racing should be maintained due to the potential losses a number of operators face; a tax exemption for gaming machine operators should be introduced; GST should be removed from totalisator duty as this is not value added; gambling duties should be increased to fund gambling treatment services; and gaming revenue should be treated just like any other revenue.

Charities

F.23 A number of submissions discussed the issue of the taxation of charities. The common themes presented by submitters dealt with the definition of charity for tax purposes, and more specifically the limits on deductions and rebates for donations to charities and the non-refundability of imputation credits.

Other Issues

F.24 While some submissions raised a number of other issues, the above are the key issues raised. Some of the other issues raised included:

- abolishing cheque duty;
- introducing a Tobin tax;
- potential compliance costs of introducing imputed income on owner-occupied housing;
- deductibility of childcare; and
- taxing vet clubs.

ANNEX G

TERMS OF REFERENCE FOR THE REVIEW OF THE TAX SYSTEM

Functions

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

The functions of the Review will be:

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

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

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

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

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

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

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

Purpose

In the budget speech the Government announced:

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

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

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

Task of the Tax Review

The Tax Review will:

- (a) assess the extent to which the tax system can contribute to broader social and economic objectives such as encouraging secure, high-quality employment, generating a fair distribution of income, maintaining a sustainable environment and promoting higher savings;
- (b) Recommend structural changes for the tax system, if appropriate. In doing so the Review will focus on the following questions:
 - (i) Can the tax system be made fairer in its role of redistributing income? This includes considering whether the income tax base should be broadened and the extent to which marginal rates should increase with levels of income, wealth and expenditure. The Review should consider the best mix between different tax bases such as income, consumption, financial transactions and wealth.

- (ii) How can the tax system be designed to encourage desirable behaviour (eg, work and savings) and discourage undesirable behaviour (eg, the wasteful use of non-renewable resources)?
 - (iii) How can the level of tax that is reasonably required by government for the provision of essential social services such as health, education, superannuation and social welfare be achieved reliably in the medium and long-term bearing in mind the need for the tax system to be an effective instrument of fiscal policy in the management of the economy?
 - (iv) Do the tax system and tax rates need to be modified in light of new technology and international competition?
- (c) The Tax Review will report on progress to the Minister of Finance, the Minister of Revenue and the Minister of Economic Development at regular intervals during the course of the review.

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

Process Expectations

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

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

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

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

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

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