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To: Minister of Finance

AIDE MEMOIRE: AIDE MEMOIRE: DELIVERING A BALANCED TAX PACKAGE

This note provides you with advice on how the tax package can be improved to better create incentives to work, save and invest. It sets out the options for delivering a package with stronger growth incentives, whilst retaining revenue neutrality and further improving fairness, efficiency and integrity of the tax system through additional base broadening measures.

Why a more balanced package?

The current package provides a strong message around personal work incentives and a shift from consumption to saving, with significant personal tax rate cuts and the increase in tax on consumption through the rise in GST. However, to produce a broadly revenue neutral package, it involves a switch in the burden of tax from personal taxes to taxes on business.

The current package is therefore weak around creating corporate incentives to invest and only partially tackles the bias towards property investments. If the government wants a package which promotes investment as well as savings and work (as Treasury recommends), we need measures to promote corporate investment – with the favoured option being a cut in the rate of company tax. Large base broadening measures for targeting property have been ruled out. However, moving to a bright line test for investment property would give the package more credibility in respect of targeting identified gaps in the taxation of property.

The package includes a number of measures aimed at broadening the base (reducing tax deductions in this case) which fall on business. A cut in company tax would rebalance the package, offsetting some of the increased tax burden on business, and promote incentives for business investment in New Zealand.

We consider that a reduction in the company tax rate, alongside base broadening measures is worth pursuing as:

- High corporate rates discourage investment and productivity improvements.
- Economies are increasingly open and average tax rates can influence global investment decisions; statutory rates can influence where profits are declared
- A tax reform package without incentives for business investment is not consistent with the Budget theme of savings investment and growth.

A fuller explanation of the rationale for a company tax rate cut is included in Annex 1.

Additional base broadening

To enable a broadly revenue neutral package, if a company tax rate cut (to 28%) is included, further principled base broadening measures can be introduced to provide revenue for personal tax rate cuts. These would allow across the board personal rate

cuts which ensure that most individual New Zealander's are better off, to be affordable. These measures, outlined in table 2 of the accompanying A3, will also help improve the fairness and efficiency of the tax system. These additional base broadening measures could deliver revenue of around $335-355m per annum by the end of the forecast period. These measures would reduce the tax package deficit from over $800m to around $485m. These measures include:

- **Tobacco Excise**: existing proposals on raising tobacco excise which will be discussed at Cabinet next week.
- **5 year Bright line test**: residential property (excluding the family home) sold within 5 years of purchase would be subject to tax on any gains. Equally, any losses would be deductible for tax purposes. Options of a 7 or 10 year test could also be considered.
- **GST Phoenix Schemes:** These changes would improve the functioning of the GST rules and GST integrity by removing the ability for aggressive/fraudulent taxpayers to deplete the GST base in respect of input tax credit claims on certain high-value transactions (such as real property).
- **Increase totalisator duty:** removal of the totalisator concession provided to NZ Racing Board (NZRB) in 2006 (where the rate of duty paid by the NZRB was aligned with the rate of duty paid by casinos). Casinos pay income tax which justifies having a lower rate of duty. NZRB does not pay income tax.

Treasury and IRD will provide you with a report on options for base broadening by the end of next week. In addition, we could assess options for alcohol excise – as Minister Power raised in a previous Joint Ministers meeting – including equalising the excise rates per unit of alcohol.

Alongside the additional base broadening measures, there are a range of alternative personal rate reduction options which would enable a broadly revenue neutral package whilst ensuring that all income ranges will be better off from the tax changes. Whilst these may reduce the level of personal tax cuts *in toto*, they remain consistent with a reform package which promotes incentives to work and save. As highlighted in table 5.1 and chart 5.3 all these options would see each income group better off than their neutral rate (the rate at which the GST increase would fully offset the decrease in personal tax).

Options

We have assessed the affordability and distributional impacts of these options. Whilst to some extent some elements of the analysis are relatively crude and further work is required on the detailed costings, we consider that a package including personal and company tax rate reductions along with base broadening measures can enable a broadly revenue neutral package delivering work, saving and investment incentives.

It should be noted that the contingency provision included in the A3 tables may change as exact transitional costs associated with provisional tax from lowering the personal and company tax rates have yet to be determined. This is not expected to affect the out year figures.

Given the potential for increased revenue from base broadening measures, if all these measures were introduced, a broadly revenue neutral package would only require

small changes to the personal tax cuts. Without changes to the personal tax package (10.5/17.5/30/33) this package would produce an annual deficit of between $325m and $525m over the forecast period (Scenario A).

Personal tax rate thresholds of 10.5/18.5/30/33 (Scenario B) would deliver a broadly revenue neutral package with fiscal balances ranging from -$220m to $95m (-$110m in aggregate over the forecast period, -$30m per annum in out-years). As shown in chart 5.3 the distributional impact of this package would be to produce a steadily increasing level of real disposable income across the income spectrum, only marginally below the starting personal rate package.

However, there are a range of alternative balanced package options which can deliver revenue neutral or positive results which can be considered, each of which has different trade-offs in terms of incentives to work, save and invest as well as the equity implications. Scenario C (10.5/18/33) would provide net positive revenue over the period of $405m. Within such options, adjustments to the tax thresholds could be considered to deliver a revenue neutral package and influence the equity and efficiency tradeoffs.

There is a further option (scenario D) of delivering a company rate cut without further base broadening measures. This is delivered through personal tax rates of 10.5/18.5/33 and provides positive revenue of $25m in out years (-$5m in aggregate over the forecast period). However, this option does not produce the same efficiency improvements that the base broadening measures bring, nor does it provide as consistent a set of incentives across the range of incomes. In particular, those earning around 70k benefit only very slightly, and benefits to earners below 70k are also low, so arguably it represents the least progressive of the options.

We have not considered savings from spending programmes within these assessments. Alongside, or instead of base broadening measures, there may be a number of spending reform options which could be implemented to allow for personal rate cuts. It should be noted that finding realisable savings may be difficult and would require negotiation with Ministerial colleagues and a full assessment of policy implications.

[information deleted in order to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials]

Assessment of trade-offs

An assessment of the more balanced savings and investment package against the five key taxation objectives supports the consideration of such an option:

Efficiency and growth: A more balanced package including personal and corporate rate cuts provides incentives to work, save and invest. A package involving deeper personal rate cuts and fewer base broadening measures, with increased taxes on business and no corporate rate cut would fail to deliver investment incentives for business, potentially worsening incentives for large sections of the corporate sector;

Equity: All broad income groups benefit from the tax changes, with personal rate reductions at least offsetting the impact of increased GST for all groups. The proposals included in this note provide relatively smaller benefits to those income earners between $14k-70k than the starting package. This also means that those on higher incomes also benefit proportionally less. However, the top rate is relatively low, and the base broadening and maintenance measures should increase the overall fairness of the tax system. As this will enable a cut to the company rate (beneficial to the economy as a whole, including job creation) we consider the marginal equity impact of this option to be worth it;

Integrity: Base broadening measures further improve the integrity of the system, reducing opportunities to avoid tax. Reducing the corporate tax rate further below the trust rate and top personal rate does potentially create integrity problems. However, the gap remains relatively small and, as set out in previous reports[1] we consider that aligning the personal and trust rate is more important than aligning with corporate rate. As we have previously advised, we consider that further integrity measures will be required in the future to prevent erosion of the tax base, via incorporation, for example.

Compliance and administration: Inland Revenue have estimated that the administrative costs of the changes in the starting package will involve one-off costs of around $10m. We do not anticipate that the further measures in this package would materially increase that figure.

Revenue: The full package of (adjusted) personal rate cuts, company rate cuts and base broadening measures can deliver sufficient revenue to remain overall revenue neutral.

Next steps:

This note demonstrates that a company rate tax cut, as part of a more balanced tax package, is affordable. If you would like to pursue a balanced package along these lines, it would be useful to indicate which options (and variations) you would like to be fully worked up.

[1] T2010/119: Tax system integrity and the alignment of tax rates

If further base broadening measures – including a 7 or 10 year bright line test - are to be included in the package, these will need to be discussed with the Prime Minister and other Ministerial colleagues.

Any spending programme savings options would need to be discussed with Ministerial colleagues, along with a full assessment of the policy implications. It would be useful to indicate if you would like any of the spending reform options working up in more detail.

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Annex 1: Treasury position on the rationale for a reduction in the company tax rate.

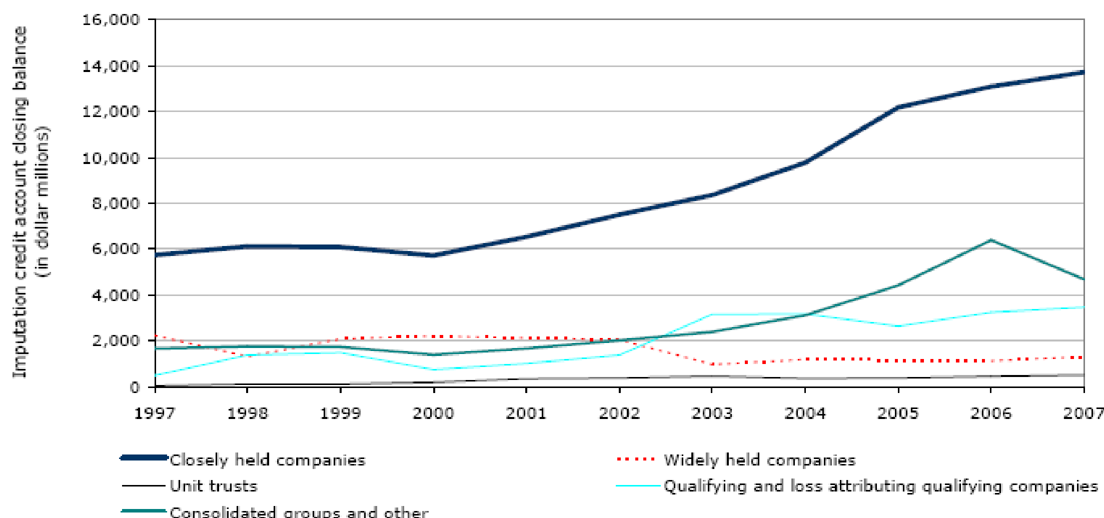
The advice provided by Treasury in our Briefing for Incoming Ministers, and largely endorsed by the Tax Working Group, is that growth potential will be improved by reducing the demands placed on relatively harmful tax bases and by reducing tax-induced distortions in taxpayer behaviour (both labour supply and investment and savings behaviours). The current package being considered by Ministers is consistent with this advice in most respects, with a re-weighting from income tax to GST, reducing tax preferences, particularly on depreciable property, and integrity measures such as thin capitalisation and LAQC changes.

The stark potential inconsistency relates to the company tax rate. In the absence of a reduction in this rate, the heavy reliance on depreciation denial as the key base broadening measure in the package currently being considered, will increase the total tax burden on companies, broadly equivalent in revenue terms to returning to a 33% company tax rate. This appears inconsistent with the growth objectives of the package generally, and the particular objectives of improving incentives for domestic firms to 'grow their business' and our relatively poor savings and investment performance.

The primary policy motivation for these base broadening measures is to reduce tax preferences for particular forms of investment. Reducing these preferences causes capital to flow to investments that are more productive for the economy as a whole. However, in the absence of rate reductions, these measures also push up average tax rates on corporate profit.

One solution to this conundrum is to use base-broadening to reduce investment distortions, and use the revenues to lower tax rates. This redirects capital to more productive uses and reduces tax on currently fully-taxed activities. These two policy "wins" is the logic behind the "broad-base low-rate" approach. The alternative approach of less base broadening and an unchanged tax rate, achieves neither of these goals.

Although both depreciation loadings and tax cuts can boost firms' retained after-tax profits, tax cuts coupled with economic depreciation rates direct the increased retained earnings to firms making real, not just tax, profits. Many small companies 'grow their business' without necessarily making large investments in either buildings or plant and machinery. For example, they may 'invest' primarily in more, and more highly skilled, workers rather than capital structures. Such companies will therefore be little affected by the proposed base broadening via changes to depreciation but would be beneficially impacted by a corporate tax rate cut. This can operate both via their increased ability to re-invest their company's profits (a great deal of literature confirms firm preferences for internal sources of finance) and because, despite New Zealand's imputation system, the final tax rate on profits in many closely-held and some larger companies is not the top personal rate. The imputation credits balances retained by companies represent retained profits, taxed only at the company rate.



Treasury also considers that a reduction in the company tax rate would encourage increased foreign investment in New Zealand, which is likely to deepen the capital stock and improve productivity. While foreign investment consists of a combination of infra-marginal investments (possibly including economic rents) and marginal investments, clearly some new marginal investment would take place.

Concerns with distortions caused by a 5c gap between the company and top personal tax rates need to be kept in perspective. The current NZ gap of 8c is low by international standards. A report commissioned by Treasury for the TWG[2] lists NZ as having the 6th-lowest gap of the 20 countries sampled, and half the countries have gaps of 15c or more, suggesting that with appropriate integrity measures much larger gaps can be sustained. A 5c gap would be a further improvement on the status quo. It is less than the current 8c gap, and less than the historic 6c gap between the 33c company and 39c personal tax rate. Also, crucially, such a distortion affects *how* an investment is made (e.g. through a company instead of individually) and not *what* investment is made (e.g. in real property or in a debt instrument). The economic costs of the second type of distortion are likely to be greater than the costs of the first type of distortion. The second type of distortion would be *reduced* by reducing the company tax rate.

The statutory corporate tax rate is especially important for companies that have options around where they ‘book’ their corporate profits or the tax deductions that reduce corporate tax liability (e.g. where they sources company borrowing and make interest payments to). These decisions are affected by New Zealand’s corporate tax rate relative to other countries’ rates. There is considerable and robust international evidence that many larger or multinational companies are highly responsive to these international corporate tax rate differences. For New Zealand, the Australian corporate rate is likely to be especially important but is not the only rate of relevance (with Asia, Europe and the US being possible destinations to transfer profits for some New Zealand companies). Setting New Zealand’s corporate tax rate below Australia’s by 2-3

[2] *Capital Taxation in New Zealand: a Review from an International Perspective* by Duanjie Chen and Jack Mintz.

percentage points, or maintaining parity, would be expected to impact on such companies' profit and/or debt locations choices.

From a strategic perspective, we see risks in New Zealand, as a capital-shallow investment-seeking economy, having a statutory tax rate for companies that is increasingly out of step with OECD comparators, then driving the effective tax rate even higher through base broadening measures without offsetting tax rate reductions.

In addition, if this opportunity to lower the company tax rate while broadening the company tax base is not taken, and international developments continue to increase pressure to lower the rate, Ministers may in future need to consider packages that reduce the company tax rate with no (or inadequate) base broadening measures, requiring reductions to be funded from elsewhere.

Annex 2: *[information deleted in order to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials]*