Regulatory Impact Statement

Options for tax reform for inclusion in Budget 2010

Agency Disclosure Statement

This Regulatory Impact Statement (RIS) has been prepared by the Treasury and Inland Revenue. It discusses, at a high-level, a range of potential changes to the makeup of the tax system that could form options for further development.

Further detailed analysis of a coherent package of tax changes for inclusion in Budget 2010 will be undertaken as the policy development process advances.

Other potential areas of tax reform that would require more detailed analysis, design and implementation than time would allow for inclusion in Budget 2010 have not been included as Budget 2010 options at this stage. These may be considered over time as part of wider strategic tax reform.

A key assumption in this policy process is that any tax package for the 2010 budget must be revenue neutral, i.e. cuts in one form of taxation must be funded by increases in tax revenue elsewhere.

Changes that may be made in Budget 2010 will also need to be consistent with the Government's equity objectives. These objectives have not yet been explicitly set and will be informed by further work to be undertaken into the precise impacts of a Budget 2010 tax package.

This RIS only identifies areas of the tax system for further policy investigation and development in the lead-up to decisions being made for Budget 2010. It is expected that any tax reform package developed for the 2010 Budget will be substantially consistent with the Government's commitment to deliver better and less regulation, but this will be confirmed in the RISs that will be prepared for Cabinet consideration when deciding on the tax reform proposals that are to be progressed.

All of the key structural tax reform issues noted in this paper have been considered by the Tax Working Group (TWG) in its review, over the past seven months, of the key medium-term tax policy challenges facing New Zealand. The TWG, established by Victoria University of Wellington, comprises experts in fields such as taxation law, economics and accounting from the private sector and academia and is assisted by policy officials from the Treasury and Inland Revenue.

The Group received considerable public feedback during the process which has been made available to officials from Treasury and Inland Revenue. The Group has published their background papers and summaries of their discussions on the internet (at www.victoria.ac.nz/sacl/cagtr/twg/) throughout this process. These papers and summaries have been the subject of much media comment and a number of articles. In addition, a summary of their deliberations was discussed at a public conference held on 1 December 2009, and their findings were outlined in their recent report entitled *A Tax System for New Zealand's Future*.[1] Accordingly, the process and reform options under consideration have been in the public domain for some time with the ability for the public to contribute thereon. This is broadly consistent with the Generic Tax Policy Process (which includes a consultation process that most tax reform proposals are subject to).

Robin Oliver, Deputy Commissioner, Inland Revenue Department	Bill Moran Manager, Tax Strategy The Treasury
19 January 2010	19 January 2010

1 Victoria University of Wellington Tax Working Group (2010), *A tax system for New Zealand's future*, available at http://www.victoria.ac.nz/sacl/cagtr/twg.

Status quo and problem definition

The current tax settings

New Zealand's main taxes are:

- Personal income tax, levied using a progressive rate structure from 12.5% up to 38%. The existing personal tax system is not generally indexed for inflation, and it relies heavily on self-assessment. This raised $28.5 billion in 2009, 53% of the total tax take.
- Company tax, levied at a flat rate of 30%. The company tax system is complemented by a system of imputation to prevent double taxation of company income; to ensure full taxation of New Zealand resident shareholders at their marginal tax rates; and to support the taxation of the New Zealand sourced income of foreign shareholders. This raised $9.3 billion in 2009, 17% of the total tax take.
- GST, levied at 12.5% on virtually all domestic consumption. This raised $11.6 billion in 2009, 21% of the total tax take.
- A range of excises on petroleum, tobacco and alcoholic products, some tariffs on imports, road-user charges and stamp duties. These raised $4.8 billion in 2009, 9% of the tax take.

There is also a targeted social assistance (Working for Families) programme delivered in the form of tax credits via the tax system. In 2009, this cost $2.7 billion.

Problems with the current tax settings

Broad-base low-rate tax framework

Economic theory suggests that to minimise the economic costs of taxation, taxes should ideally be levied on bases that are less responsive to the imposition of the tax. However, it is difficult, and it may be inequitable, to assess and target higher tax rates on those activities that are least responsive.

As the best practical alternative to this approach, a broad-base low-rate (BBLR) tax framework, that involves taxing a wide base at low rates, aims to improve economic efficiency by reducing the distortions to economic decision making caused by taxes. By employing broad tax bases, and applying low rates to those bases, behavioural distortions caused by the tax system are reduced. In other words, a BBLR framework aims to make tax a neutral factor in decisions so that they are made on the basis of underlying economic merit. Available evidence (e.g. findings from the 2001 tax review[2] and the 2010 Tax Working Group (TWG) report[3]) suggests that, generally, a BBLR framework is the best practical approach to tax policy in New Zealand.

It should be noted that there is no single, ideal tax rate that should be applied to an effective BBLR tax framework. The rate applied will be largely guided by the Government's revenue needs. Also, in certain situations, different rates can apply to different tax bases under a BBLR. This can occur, for example, when it is clear that a particular tax base is sensitive to tax (e.g. inbound debt investment via the approved issuer levy (AIL)) and it is therefore appropriate to levy a lower tax rate to that base.

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2 http://www.treasury.govt.nz/publications/reviews-consultation/taxreview2001

3 Victoria University of Wellington Tax Working Group (2010), *A tax system for New Zealand's future,* available at http://www.victoria.ac.nz/sacl/cagtr/twg.

Between the late 1980s and 1990s, New Zealand had an effective BBLR framework in place. However, due to a series of individual changes made to various elements of the tax system over the last 20 years, the effectiveness of New Zealand's BBLR tax framework has been reduced. Also, globalisation and tax changes in other countries over the last 10-20 years have made a difference to the merits of our current system.

Reliance on taxes most harmful to growth

In 2009, 70% of the total tax take was received from personal income and company tax.

A number of recent international (including OECD) studies[4] have concluded that some taxes are more damaging to economic growth than others. In particular, they have found that personal income and company taxes (which apply to more mobile bases) are the most harmful to growth, while certain property taxes (more immobile bases) and consumption are least damaging. Reliance on the most growth damaging bases is creating adverse incentives to work, save, invest and consume.

This evidence suggests a shift in emphasis from more mobile bases to less mobile bases is warranted in order to reduce the growth damaging effects of the existing system.

Inconsistent treatment of different forms of income

There are other aspects of New Zealand's tax system which are harmful for revenue integrity, economic efficiency and productivity growth. These include:

- large differentials between the top personal and corporate rates of tax; and
- different tax rates applying to different sources of income and different forms of investment.

The current system applies a range of different tax rates and treatments to the different entities through which taxpayers can conduct their tax affairs. Examples of these disparities are illustrated in the table below:

Entity	Marginal tax rate
Individual	0%-38% depending on level of taxable income.
Portfolio Investment Entity (PIE)	Final tax of 19.5% or 30% (12.5%, 21% or 30% from 1 April 2010).
Company	30%, then marginal personal income tax rate of shareholder (0-38%) upon payment of a dividend.
Trust	Income retained by trust – 33% final tax. Income distributed immediately to beneficiaries – generally marginal tax rate of beneficiary (0%-38%).
Qualifying company/loss attributing qualifying company	30%. However, there may be claw-back on payment of dividend to high marginal tax rate recipient.
Partnerships	Marginal tax rate of each partner.
Superannuation funds	Generally a 30% final tax.

4 Johansson, A., Heady, C., Arnold, J., Brys, B., Vartia, L. (2008), *Taxes and Economic Growth,* OECD Working Paper 620, at http://ideas.repec.org/p/oec/ecoaaa/620-en.html

When New Zealand introduced its imputation system in 1988, the company tax rate, the trustee tax rate and the top personal tax rate were all aligned at 33%. This meant that companies and trusts could not be used to shelter income from higher personal tax rates.

However, the increase in the top personal tax rate and the subsequent lowering of the company tax rate has opened up a substantial gap between the company tax rate, the trustee rate and the top personal tax rate. This diversity of tax rates means individuals can shelter personal income from higher effective marginal tax rates (MTRs) using different vehicles, reducing progressivity and undermining the integrity and efficiency of the tax system.

There is significant evidence of tax-planning to mitigate the exposure to high MTRs. For example, Inland Revenue data shows increasingly large 'spikes' in the taxpayer income distribution at incomes around $38,000 and $60,000 (the previous tax threshold levels where tax rates increased) , with 'troughs' immediately above those values.

As a result of this tax-induced behaviour, investment may be diverted into those forms of investment producing a given level of post-tax returns, despite potentially higher pre-tax returns elsewhere. This reduces national welfare through lower overall returns to the economy.

In addition, different entities can also be utilised to shelter income from various social taxes or to enable people to receive social support. Such behaviour creates serious and unsustainable fiscal and tax system integrity risks for the government. Also, these disparities can reduce equity between taxpayers and cause uncertainty in the boundaries between tax avoidance and the legitimate choice by a taxpayer to arrange their affairs in the most efficient manner.

In considering any potential tax reform, there is therefore a need to consider, to the extent possible, reducing differences in tax rates applicable to individuals, different business vehicles and investment forms, and to different sources of income.

High effective marginal and average personal income tax rates for many taxpayers

For income taxes in particular, the BBLR framework involves taxing a wide base of income at low MTRs on the basis that the lower the tax imposed, the lower the efficiency cost of the tax. High MTRs negatively affect efficiency by unduly influencing decisions to work, save, invest, and consume, leading to less efficient allocation of scarce resources.

By reducing the associated after-tax returns, high MTRs may:

- discourage individuals from investing in their own skills and human capital;
- discourage people from participating in the labour force or from seeking more productive work opportunities;
- make businesses less willing to undertake risky investments;
- discourage innovation and entrepreneurship;
- inhibit business growth; and
- increase the likelihood that productive businesses will exit the market.

Further, the introduction of, in particular, Working for Families has meant that many taxpayers face high MTRs in excess of the top tax rate on personal income of 38%. As noted above, there is also significant evidence of tax-planning to mitigate the exposure to high MTRs which is undermining the integrity and efficiency of the tax system.

Fiscal drag (arising from the non-indexation of tax thresholds over time) will mean that increasing numbers of taxpayers will pay the top marginal tax rate. Without change, it is estimate that by 2021/22 the average wage earner will face a marginal tax rate of 38%. Fiscal drag will also increase the average tax rates paid by individuals over time, and thus worsen incentives to enter the labour force, and to remain in or migrate to New Zealand.

High average tax rates on personal and corporate income also impact productivity decisions, and may be relevant to decisions about whether to enter into the labour force, or to migrate.

International competitiveness of personal income and company tax rates

Personal income

Although New Zealand's top personal marginal tax rate of 38% is not particularly high by international standards, this top rate does apply at income levels lower than many other countries. Non-indexation of tax thresholds exacerbates this over time by increasing the number of taxpayers facing the highest MTR as a result of inflation.

New Zealand has a highly mobile and sought after labour force that can migrate to Australia (in particular) with relative ease. As well as affecting decisions on work participation within New Zealand, high personal tax rates can also affect the decision of taxpayers, in particular highly skilled workers, to stay in New Zealand or work abroad.

By one estimate, around 17% of skilled New Zealanders now live abroad, the third highest in the OECD after Ireland and Luxembourg.[5] Any further deterioration in emigration levels may cause problems for New Zealand in terms of maintaining its tax base, enhancing its skills and knowledge bases (and therefore its productivity potential), and more generally, maintaining or improving our living standards.

Companies

As with personal income taxes, an increasingly globalised economy is putting downward pressure on company tax rates in New Zealand. Capital and companies are becoming more mobile.

In 1988, when the company tax rate was reduced to 33%, New Zealand had one of the lowest corporate tax rates in the world. Over the last 20 years, however, this situation has changed as corporate tax rates internationally have trended downward. While New Zealand's company tax rate has reduced to 30% during this time, the average company tax rate for small OECD countries is now 26%.

Further company tax rate reductions overseas, in particular in Australia, could leave the New Zealand tax base vulnerable, as companies may be encouraged to either repatriate overseas or, with respect to multinationals, stream profits away to lower tax countries by using aggressive transfer pricing arrangements or by thinly capitalising their New Zealand operations.

5 A profile of immigrant populations in the 21st Century: Data from OECD countries – OECD, 2008

However, to the extent that foreign inbound investment is not sensitive to the imposition of New Zealand tax, the economic benefit of lower corporate tax rates will be reduced. Foreign inbound investment may not be sensitive to New Zealand taxes due to foreign-owned firms deriving location specific economic rents (i.e. 'super profits') from New Zealand, or because they can claim a tax credit for any New Zealand tax levied in their own country. Reducing company tax on these investments would reduce New Zealand tax revenues (without increasing investment incentives). For New Zealand-owned firms, reductions in the company tax rate could have beneficial effects in terms of increasing the company's after-tax returns.

Non taxation of certain types of economic income

Under a BBLR framework economic income should be taxed as broadly as possible. While New Zealand's tax base is relatively broad by international standards, the absence of a comprehensive capital gains tax (CGT) means that income from certain forms of capital is not taxed.

This may result in the following consequences:

- tax avoidance and arbitrage opportunities, and a potential net revenue loss to the government;
- undermining of the horizontal equity of the tax system;
- a potential bias, depending on circumstances, in favour of certain types of investment (e.g. rental housing); and
- other income tax rates that are higher than they would otherwise need to be, in order to meet revenue requirements.

Expected outcomes in the absence of any further government action

The current fundamental features of the New Zealand tax system were designed in the 1980s. Since that time various individual changes have been introduced in order to deal with taxation and social policy issues that have arisen over time. Some of these changes, whilst necessary or desirable in their own right, have undermined the overall integrity and coherence of the tax system. Examples include capping the PIE tax rate at 30% and the changes to personal and corporate tax rates.

As a result, the resulting current tax system is unlikely to be sustainable over time. In addition to the impact of fiscal drag, and the competitiveness concerns discussed above, demographic changes over the next 30-50 years will also place additional pressures on the system. These pressures include the likelihood that expenditure requirements (and therefore, necessary revenue) will need to be increased, particularly in relation to health and superannuation payments.[6]

Without fundamental tax reform New Zealand will not be able to deliver an effective and efficient tax system that is fair and supports economic growth. The increasing pressures on the personal and company tax rates, as well as the integrity issues that have been identified, mean that reform is needed in the short-term rather than the medium term. Retaining the status quo will, over time, further exacerbate erosion in the efficiency, coherence and integrity of the tax system, raising significant sustainability risks.

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[6] For further information, see *Challenges and Choices: New Zealand's Long-Term Fiscal Statement*, The Treasury, at http://www.treasury.govt.nz/government/longterm/fiscalposition/2009, and *Population Ageing and Taxation in New Zealand* (*http://www.victoria.ac.nz/sacl/cagtr/twg/Publications/Population-Ageing-Taxation.pdf*)

Objectives

The tax system aims to raise the required revenue for Government at least economic cost. The overall objectives of tax reform are to:

- reduce the impact of taxation on the efficiency and growth of the economy;
- have a tax system that supports New Zealand's competitiveness globally in a sustainable manner; and
- improve the fairness, coherence and integrity of the tax system by reducing opportunities to avoid tax.

Tax reform inevitably results in some change in the burden of taxation. The redistribution of income desired through the tax system, alongside redistribution via other government spending policies, ultimately requires value judgements about what is considered appropriate for society. As such, another objective of tax reform is to be consistent with the government's equity objectives.

The primary aim of the analysis undertaken to date is to outline whether fundamental tax reform could, in fact, deliver the broad objectives noted above (compared to the current tax system).

If it is considered that these objectives can be achieved, and fundamental tax reform is therefore warranted, it is then necessary to establish the potential components of fundamental tax reform that could achieve an improved tax system. The merits of these individual components would also be measured against the broad objectives of tax reform.

Finally, of the possible tax reform components that could be considered further, the analysis undertaken aims to establish which elements can feasibly be considered (from a policy perspective, as well as fiscally and operationally) for inclusion in the 2010 Budget with a view to implementation by 1 October 2010 or 1 April 2011 (or, if applicable, income years from as early as the 2011/12 income year).

Potential tax reform options that could be included in a tax reform package for Budget 2010 would warrant further and more detailed advice from officials, as further analysis will be required before any detailed policy decisions can be made.

Areas of tax reform that would require more detailed analysis, design and implementation than time would allow for inclusion in the 2010 Budget could still be considered as part of wider and longer term strategic tax reform.

A key assumption for any tax reform package for inclusion in Budget 2010 is that revenue target should remain as they are currently, i.e. cuts in one form of taxation must be funded by increases in tax revenue elsewhere. Treasury will advise separately on its view of the appropriate levels of government spending/revenue and debt as part of the wider Budget 2010 process. Tax policy advice will be integrated into the wider fiscal considerations throughout this process.

Regulatory impact analysis

There are two main options available to government in relation to the problems with the tax system. These are:

1. Retain the status quo.
2. Consider substantially reforming the structure of the tax system.

Assuming that the current tax settings will remain as they are into the future is not plausible because the tax system is continually evolving. In the usual course of events, changes to the tax system are made on a case-by-case basis. This process requires government intervention and typically adheres to the Generic Tax Policy Process. For this purpose, the status quo is defined in this context.

This Regulatory Impact Statement reflects the first part of a policy process to consider tax reform. The questions relevant for this stage of the policy development process are:

- Is structural tax reform worth considering at all?
- If so, what areas of reform might be feasible to consider for Budget 2010 as a first step?

Consideration of structural tax reform compared to the status quo

Structural reform is considered to be a coherent rebalancing of how tax is raised across a wide range of tax bases. The potential benefits from structural reform could be significant compared to the status quo. This is particularly relevant under a revenue neutral constraint since reductions in one form of tax must be simultaneously coupled with a revenue increase elsewhere.

The Tax Working Group has canvassed a number of problems with the tax system and outlined possible future directions.[7] Considering structural reform of the tax system would usefully leverage off this work and the recent public debate on these matters.

There are small costs and risks associated with *considering* structural tax reform. Generally, the costs come in the form of concentrated pressure on Treasury and Inland Revenue resources (as opposed to the ongoing and phased nature of the usual tax policy work programme), and the costs to stakeholders in participating in consultation where applicable. There are risks to the existing tax policy work programme if Treasury and Inland Revenue resources are largely diverted to considering structural reform. However, many of the items on the tax policy work programme are considered lower priority than structural reform, and any risks could be somewhat mitigated by reprioritising the current work programme.

Ultimately, whether or not the actual benefits of *implementing* structural tax reform would outweigh the costs and risks depends critically on the details of tax changes being made and how they are packaged together.

In any case, for this stage of the process, the potential gains from considering structural reform are considered to significantly outweigh the costs of considering the policy issues involved.

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7 Victoria University of Wellington Tax Working Group (2010), *A tax system for New Zealand's future,* available at http://www.victoria.ac.nz/sacl/cagtr/twg.

Areas of structural tax change for potential consideration

Key components of potential tax reform are outlined below, and are discussed in terms of their feasibility for consideration in Budget 2010. They are drawn from the work of the Tax Working Group, which has been considering reform of the tax system over the past seven months.[8]

Reducing the tax rates applying to mobile bases and increasing the taxes on more immobile bases may improve the efficiency of the tax system, improving our growth prospects and improving the sustainability of the tax system. In conjunction with tax base broadening measures, tax rate reductions could help to reduce the current reliance on personal income and company tax.

Reducing income tax rates

Reducing income tax rates are a crucial part of any structural reform package that seeks to shift the tax system away from bases that are more damaging to efficiency and growth.[9] As such, there are significant benefits of considering reductions in personal and corporate income taxes for Budget 2010.

Personal tax

The risks to considering changing the personal tax rates and thresholds in the 2010 Budget are low since:

- the case for reducing personal tax rates is already well established,[10] and consideration of the remaining details is considered achievable in the time available;
- changes would also be relatively straightforward to make. Implementation-wise, changes could likely be effected by as early as 1 October 2010.

WFF

The interface between WFF tax credits and the personal tax system contributes to the efficiency and integrity problems identified earlier, and it provides a means for significant redistribution within the tax system. This was noted by the Tax Working Group,[11] which recommended that WFF should be considered as part of a separate review of how the wider welfare system interacts with the tax system.[12]

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8 Victoria University of Wellington Tax Working Group (2010), *A tax system for New Zealand's future,* available at http://www.victoria.ac.nz/sacl/cagtr/twg.

9 Victoria University of Wellington Tax Working Group (2010), *A tax system for New Zealand's future*, available at http://www.victoria.ac.nz/sacl/cagtr/twg.

10 Policy Advice Division of the Inland Revenue Department and by the New Zealand Treasury; *Estimating the Distortionary Costs of Income Taxation in New Zealand* (http://www.victoria.ac.nz/sacl/cagtr/twg/Publications/5-estimating-the-distortionary-costs-of-income-taxation-in-newzealand-treasury.pdf).

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

12 Victoria University of Wellington Tax Working Group (2010), *A tax system for New Zealand's future*, available at http://www.victoria.ac.nz/sacl/cagtr/twg.

Although fundamental change to WFF may lead to considerable efficiency, fiscal and fairness benefits, the costs and risks of considering changes in time for Budget 2010 are high since:

- in-depth consideration of the policy issues in terms of its interaction with the benefit system as well as the tax system is required and may not be achievable in the time available without significant risk;
- resourcing the consideration of policy issues would require a dedicated team of Treasury, Inland Revenue and Ministry of Social Development officials, and may impose risk on consideration of other parts of a tax package.

However, consideration of smaller, non-structural changes to the existing WFF system, including strengthening its integrity, is considered possible for Budget 2010 without considerable cost and risk.

Corporate tax[13]

An additional benefit of considering the corporate tax rate in Budget 2010 is that it if Australia decides to reduce its corporate tax rate, New Zealand may be able to respond quickly if considered desirable.

The risks to considering changing the corporate tax rate in the 2010 Budget are low since:

- consideration of the desirability of reducing the corporate tax rate is considered achievable in the time available; and
- changes would also be relatively straightforward to make. Reduction in company tax rates could, if deemed desirable, be announced in the 2010 Budget with effect from income years from as early as the 2011/12 income year.

Associated issues that could also be considered as part of any changes in this area include changes to the thin capitalisation rules.

Trust and PIE tax rates

The integration of the top personal, trust, PIE and company tax rates are also important for the coherence, efficiency and integrity of the system. Outstanding policy issues largely relate to what the rates should be as part of a package. As such, the benefits of considering trust and PIE tax rates alongside changes to personal and corporate tax rates outweigh the costs of doing so for Budget 2010. Options for consideration include alignment of these rates, or retaining a non-aligned system but with improved integrity measures.[14]

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13 Policy Advice Division of the Inland Revenue Department and by the New Zealand Treasury; *Company tax issues facing New Zealand* (http://www.victoria.ac.nz/sacl/cagtr/twg/Publications/4-company-tax-_issues-facing-nz.pdf)

14 New Zealand Treasury and Policy Advice Division of the Inland Revenue Department; *Scenarios: Background paper for the Tax Working Group* (*http://www.victoria.ac.nz/sacl/cagtr/twg/Publications/scenarios.pdf*

GST

Increasing the rate of GST has the potential to provide significant revenue to fund reductions in income tax rates.[15] Outstanding policy issues for consideration include what the rate should be and what compensation may be required – these could be feasibly resolved in time for the 2010 Budget. Changes could likely be effected by 1 October 2010 or 1 April 2011.

Introduction of new capital taxation bases

The TWG considered the introduction of new capital taxation bases, including a land tax, a capital gains tax, and the application of a risk free return method (RFRM) on rental properties. The potential contributions of these to structural tax reform, and an analysis of their feasibility for consideration in Budget 2010, are outlined below.

Land tax[16]

Introduction of a land tax would impose an annual tax liability on landowners, calculated by reference to the value of land owned by them. As a base-broadening measure, a land tax has a number of merits:

- Given the size of the potential base, a large amount of revenue could be raised by imposition of a low rate, therefore making it suitable for a BBLR tax framework.
- As land is in fixed supply, a land tax would be efficient if imposed at a single rate across all land types (as it could not be avoided or passed on by landowners).
- A land tax would likely be a relatively easy tax to introduce, comply with and administer.

However, there are also a number of other, less adverse issues that would also need to be considered before a land tax was introduced, namely:

- There would very likely be an initial fall in the value of land if a land tax was introduced. This would effectively represent a one-off tax on landowners at the date of introduction. This may cause negative equity for some landowners.
- There may be fairness impacts by effectively taxing only one component of wealth, impacting people or groups holding their wealth in that form. It may also give rise to cashflow issues for some landowners who have lower income levels.

Detailed consideration of these policy issues would be required to determine whether the introduction of a land tax would make a positive contribution towards the medium-term strategy.

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[15] The New Zealand Treasury and Policy Advice Division of the Inland Revenue Department *Changing the Rate of GST: Fiscal, Efficiency and Equity Consideration.* (http://www.victoria.ac.nz/sacl/cagtr/twg/Publications/GST_paper.pdf)

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

Capital gains tax[17]

New Zealand's tax base already includes taxation of some capital gain income, albeit on a relatively narrow base. A comprehensive capital gains tax (CGT) would substantially broaden this base. There are a number of issues that would need to be carefully considered before deciding whether to introduce a more comprehensive CGT, and if so, in what form.

At a theoretical level, there is a strong case for a CGT. It would broaden the income tax base and make it more comprehensive. However, in reality, the arguments for and against a CGT depend on how it is applied, for example on accrual, realisation, or some combination of both.

The main arguments for introducing a CGT are:

- It would broaden the income tax base and thus reduce the existing tax-created incentives to invest in areas producing expected capital gains.
- The revenue could be used to reduce marginal rates.
- It would buttress the overall income tax base by reducing tax planning opportunities.

The main arguments against introducing a CGT are that:

- It may result in certain efficiency costs. These depend critically on how the tax is applied and include:
  - for a realisation based CGT, lock-in, whereby owners of capital assets are incentivised to delay the sale of profitable assets and accelerate the sale of badly performing assets; and
  - for an accrual-based CGT, problems around valuing certain assets and liquidity issues when people are required to pay tax when there is no associated cashflow.

Very careful consideration of all of the policy issues involved would be required before any recommendations could be made on a CGT. Any comprehensive and sustainable CGT would have to be very carefully designed and consulted on – this would likely take a significant amount of time.

RFRM[18]

One of the main areas where capital income can be systematically derived in an untaxed form is housing (e.g. investment housing). However, there are a number of methods for potentially addressing this issue in the absence of a CGT. For example, the application of a risk free return method (RFRM) on rental properties, whereby such properties were taxed at a universal deemed rate of return, could be considered.

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[17] Burman & White; *Taxing Capital Gains in New Zealand: Assessment and Recommendations;* (http://www.victoria.ac.nz/sacl/cagtr/twg/Publications/3-taxing-capital-gains-burman_white.pdf)
Policy Advice Division of the Inland Revenue Department and by the New Zealand Treasury; *The taxation of capital gains;* (http://www.victoria.ac.nz/sacl/cagtr/twg/Publications/3-taxation-of-capital-gains-ird_treasury.pdf) Coleman; *The Long Term Effects of Capital Gains Taxes in New Zealand* (http://www.victoria.ac.nz/sacl/cagtr/twg/Publications/3-long-term-effects-of-cgt-coleman.pdf)

[18] Policy Advice Division of the Inland Revenue Department and by the New Zealand Treasury; *Other base broadening and revenue raising ideas* (http://www.victoria.ac.nz/sacl/cagtr/twg/Publications/3-other-base-broadening-ird_treasury.pdf)

Introducing an RFRM would result in a complex system to implement, and there would be a number of issues that require resolution before this was possible. A RFRM on housing would therefore have to be very carefully designed and consulted on – this would likely take a significant amount of time.

Summary of analysis for considering new capital bases in Budget 2010

A benefit of considering any of a land tax, CGT or RFRM is that significant changes to the tax system could potentially be progressed in Budget 2010. These tax bases have the potential to raise a significant amount of revenue, which could be coupled with large reductions in personal and corporate income taxes.

However, inadequate consultation and scrutiny of proposals in the timeframe available would lead to considerable risks in terms of implementing a tax reform package that:

- improves on the status quo, and
- is sustainable.

Due to complex issues involved, there are significant resource implications for Treasury and Inland Revenue in terms of policy advice and design if any of these taxes were to be introduced in Budget 2010. Considering these issues for Budget 2010 would also severely limit Treasury and Inland Revenue's ability to provide policy advice on other aspects of a tax reform package. Implementation pressure on Inland Revenue would also arise, (the extent would depend on the timing of a new tax base coming into effect).

Given the significant magnitude of the risks associated with progressing any of these taxes in Budget 2010, Treasury and Inland Revenue consider their resources would be better put towards consideration of other aspects of the tax system which may be feasible for Budget 2010. Not considering these taxes in Budget 2010 does not preclude their consideration subsequently as part of a continuation of strategic tax reform.

Other base broadening and integrity measures[19]

Although there are considerable risks associated with new capital taxation bases, changes to the existing bases may more feasibly be considered for Budget 2010. There are significant benefits in considering such changes for Budget 2010, as they provide the potential for raising revenue to fund personal and corporate income tax reductions. The Tax Working Group has considered a range of possible changes, for example loss ring-fencing, and changes to the depreciation regime (to reflect economic depreciation).

Other systems of income taxation

There are possible structural alternatives to New Zealand's current broad-based low rate-oriented income tax system. Briefly, those considered by the TWG include:[20]

1. A Dual Income Tax System (where labour income is taxed more highly than capital income).

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[19] Policy Advice Division of the Inland Revenue Department and by the New Zealand Treasury; *Other base broadening and revenue raising ideas* (http://www.victoria.ac.nz/sacl/cagtr/twg/Publications/3-other-base-broadening-ird_treasury.pdf)

[20] Policy Advice Division of the Inland Revenue Department and by the New Zealand Treasury; *Company tax issues facing New Zealand* (http://www.victoria.ac.nz/sacl/cagtr/twg/Publications/4-company-tax-_issues-facing-nz.pdf)

2. A Classical System with a Deep Company Tax Cut (where the company tax rate on trading income is set low to attract foreign capital, while standard tax rates and rules apply to domestic workers and savers).

3. An ACE Company Tax System combined with a Dual Income Tax. This involves an allowance for corporate equity (ACE) that would grant a tax deduction for the cost of equity and a dual income tax system that would tax income from capital at a lower rate than labour income.

These alternative tax systems are radically different from New Zealand's current tax system architecture. They would require a significant amount of time to design and develop, consult on, and implement, and there is limited international precedent for these systems in their purest form from which New Zealand could leverage. A move to any one of these systems in the 2010 Budget is extremely risky and would almost certainly not improve on any aspects of the status quo. Other changes in Budget 2010 would not preclude any subsequent consideration of these types of tax systems.

Medium-term direction for the tax system

Treasury and Inland Revenue agree that structural tax reform is necessary to solve many of the problems with the tax system outlined in this RIS. The exact nature that this structural reform should take is still under consideration, although there is broad agreement that a coherent rebalancing across tax bases is required. Current thinking of the two departments is outlined below:

Treasury view

Through the Tax Working Group process, our own analysis, and consideration of international research, the Treasury believes that the tax system has a number of fundamental problems that are harmful to economic growth and undermine its fairness and integrity. These include:

- Heavy reliance on corporate and personal income tax bases, being the most damaging to growth and the most mobile thereby undermining New Zealand's international competitiveness.
- The current ad hoc taxation of capital, and the different rates that apply to different forms of income, undermine allocative efficiency and cause integrity problems.

We are convinced that the pressures for reform are pressing and that reform is required in the short-term. Reform needs to focus on improving the economic outcomes from the tax system – on removing barriers to growth, reducing our reliance on personal and corporate taxes, and increasing savings and investment incentives.

Treasury is not convinced that there is reliable evidence of significant economic rents being earned in the New Zealand corporate sector, nor that the potential to tax such rents, where they exist, outweighs the strong case for lower corporate tax rates to retain existing, and encouraging new, investment in New Zealand. This implies a reduction of both corporate rates (to encourage investment) and personal tax rates (to encourage savings). The pressures on corporate tax rates are particularly pressing, as the Australia's Future Tax System Review is likely to recommend a cut to the Australian corporate tax rate.

Aligning the top rate of personal tax, company and trust tax rates would largely solve a number of integrity concerns. However, the competing pressures for capital and labour internationally, and having a progressive personal income tax structure lead us to question whether tax rate alignment would be sustainable over the medium term. For these reasons, Treasury is not committed to rate alignment as a central goal of tax reform and favours a non-aligned system, where the top personal and trust rates are aligned, and the corporate rate is set at a lower level. Additional integrity measures to reduce tax-driven recharactersiation between entity forms should be introduced as part of any tax reform package.

Treasury sees a shift away from income taxes to GST as desirable as, even if revenue neutral due to compensation measures, it would improve savings incentives. Treasury would see this as detrimental if it broke the broad national consensus around the comprehensive GST base and single rate.

To address some of the integrity problems in the current system, and to remove tax-created investment biases, measures that reduce the effect of tax on capital allocation decisions, such as more consistent capital gains taxation, and appropriate treatment of depreciation, should be explored as part of a tax reform package. These may also assist in funding revenue reductions elsewhere in the package.

In the longer term, Treasury thinks that the introduction of a land tax should be considered from an efficiency and growth, integrity and revenue perspective. Careful consideration to its equity effects – particularly with regard to the transitional costs – would need to be given.

Treasury also thinks that longer-term consideration should be given to the merits of a dual income tax in the New Zealand context to promote efficiency and to improve New Zealand's competitiveness for capital.

Inland Revenue view

Inland Revenue's current thinking on long-term tax reform is that the medium-term pressure on the fiscal position, and tax integrity issues caused by the misalignment of tax rates, mean that tax reform is necessary.

In Inland Revenue's view, the integrity of the tax system would be significantly improved if the top personal tax rate was aligned with the company and trustee tax rates.

The company tax rate needs to be internationally competitive. If the downward pressure on company tax rates internationally continues, New Zealand will need to *consider* its rate. It should be noted, however, that Inland Revenue considers that the company tax base incorporates significant economic rents (i.e. profits in excess of normal rates of return). To the extent that these are earned by non-residents (e.g. foreign owned banks and oil companies) and involve location specific factors (e.g. providing goods or services to the domestic market such as banking services or exploiting domestic resources) these are rents that New Zealand can tax. Cutting the company rate could therefore provide a windfall to non-residents and require higher taxes on New Zealanders. Therefore, any cut to the company tax rate could result in an economic loss to New Zealand and, therefore, needs to be very carefully considered.

New Zealand's tax base is already fairly broad. However, the rental property sector is currently significantly under-taxed. Tax reform is considered necessary to address this issue.

There are arguments for and against significantly broadening the tax base through measures such as a capital gains tax or a land tax. On balance Inland Revenue does not favour either approach. Tax rate alignment can be funded by taxing the rental property sector more appropriately, and introducing other less significant tax base broadening measures.

If additional tax revenue is required, an increase to GST could be considered. A GST increase, together with income tax cuts, is likely to have some efficiency benefits. However, if an increase in GST is to be accompanied by measures to offset its perceived regressivity, this would significantly reduce the net revenue raised from a higher GST.

At this stage there are some differences between the departments views in terms of what particular changes may be warranted. However, the process of considering tax reform for Budget 2010 and beyond allows for further consideration and analysis of these issues. The changes that are feasible for consideration in a Budget 2010 package are not inconsistent with either department's view.

Timing of reform

The time available for considering tax reform for Budget 2010 is constrained. As outlined above, large one-off structural change in Budget 2010 would carry significant risk if new taxes were to be introduced. However, this does not preclude making a start on tax reform in the Budget. There are few benefits to delaying some tax changes, and the sooner changes are made, the sooner the benefits can be realised. Budget 2010 could feasibly make a start on improving the integrity and efficiency of the tax system, and reducing income tax rates, even if a large structural rebalancing is not achievable. Although a Budget 2010 package could include personal, and possibly company, tax rate reductions, further reductions in the future may still be desirable and could be coupled with a move to more efficient and less mobile bases, especially if fiscal neutrality remains a requirement for tax reform.

Consultation

All of the key structural tax reform issues noted in this paper have been considered by the Tax Working Group in its review, over the past seven months, of the key medium-term tax policy challenges facing New Zealand. The Group comprises experts in fields such as taxation law, economics and accounting from the private sector and academia and is assisted by policy officials from the Treasury and Inland Revenue.

In particular, this Group, established by Victoria University of Wellington in conjunction with Treasury and Inland Revenue, has considered several matters with respect to possible reform, including:

- The sustainability and competitiveness of the tax system, and existing tax bases.
- The growth, integrity, and equity properties of the current system.

- The growth, integrity and equity properties of a range of reform options, including:
  - personal income taxes, and transfer payments;
  - GST;
  - capital taxation (including the taxation of capital gains, land/property taxes, and RFRM);
  - company taxes; and
  - other base broadening options (for example, tax loss ring-fencing and various depreciation options).

The Group received considerable public feedback during the process which has been made available to officials from Treasury and Inland Revenue. The Group has published their background papers and summaries of their discussions on the internet (at http://www.victoria.ac.nz/sacl/cagtr/twg/) throughout this process. These papers and summaries have been the subject of much media comment and a number of articles. In addition, a summary of their deliberations was discussed at a public conference held on 1 December 2009, and their findings were outlined in their recent report entitled *A Tax System for New Zealand's Future.*[21] Accordingly, the process and reform options under consideration have been in the public domain for some time with the ability for the public to contribute thereon. This is broadly consistent with the Generic Tax Policy Consultation Process.

Although the TWG do not make specific recommendations on a package of tax reform, the problems identified and general direction the system should take is broadly consistent with the analysis in this paper.

Following initial decisions around the extent and nature of any tax reform, specific measures will need to be considered in detail for the purposes of developing a revenue neutral budget package. Once the dimensions of any reform are known, only certain aspects of it are likely to be the subject of targeted consultation. Due to the timeframes involved in developing a Budget tax reform package, and the likely need for Budget secrecy, the ability to consult in the usual manner will likely be constrained. The implications for consultation will be discussed in future RIS that deal with specific proposals.

Conclusions and recommendations

The tax reform options considered by the Tax Working Group that have been discussed in the preceding sections are broadly consistent with the longer term strategic tax policy views of both Treasury and Inland Revenue.

Given the problems and objectives outlined in the previous sections of this Statement, and given the early stage of the Budget process, the preferred approach at this time is to identify and limit the range of possible tax reform options that could be considered for potential inclusion in Budget 2010.

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[21] Victoria University of Wellington Tax Working Group (2010), *A tax system for New Zealand's future*, available at http://www.victoria.ac.nz/sacl/cagtr/twg.

Treasury and Inland Revenue consider that the following issues *warranting further and more detailed advice* from officials for Budget 2010 are:

- personal and corporate tax cuts;
- associated changes to trust tax and PIE tax rates;
- non-structural changes to WFF;
- increase to the rate of GST; and
- other tax base broadening and base integrity-enhancing measures.

The significant costs and risks of the following potential structural reform options significantly outweigh the benefits of proceeding with them in Budget 2010, given the associated timeframes:

- introduction of a land tax;
- introduction of a capital gains tax;
- application of a RFRM; and
- other systems of income taxation.

These are *not recommended* for consideration Budget 2010. Reform options that are not selected for the Budget will still be able to be considered at a later time as part of an ongoing process towards strategic and coordinated tax reform. Treasury and Inland Revenue officials consider that the approach outlined above will allow a manageable first step towards growth enhancing and more sustainable reform in the medium to longer term.

Implementation

At this stage, it is considered that all the reform options identified for consideration in Budget 2010 could be implemented by either 1 October 2010 or 1 April 2011 (or income years from as early as the 2011/12 income year, depending on the measure).

Further advice will be provided to Cabinet on implementation issues associated with reform options that are recommended for inclusion in Budget 2010.