11. TAX

New Zealand's tax system has much to recommend it. Income tax and GST are drawn from fairly wide bases. Economic activity is taxed more uniformly. Generally, the tax system neither penalises nor favours one activity over another.

These advantages are worth preserving. They mean the Crown raises the revenue it needs at a relatively low cost to itself and to taxpayers. Compared to alternatives, the present tax system is well placed to make a real contribution to better economic performance.

Nonetheless, there is room for improvement. In the recent rapid expansion of the income-tax base, the tax system has become more complex and difficult to understand than it needs to be. There is a need to improve the process for considering and implementing future tax reforms. The cost to taxpayers of complying with tax rules needs to be given due weight.

Close co-ordination between the tax and social-welfare systems would assist in achieving social goals, save money, and help eliminate fraud. The balance between income and consumption taxes needs to be examined. The tax system would be improved by further broadening the income-tax base and by carefully designing the international boundary, in order to eliminate remaining artificial biases in taxpayers' decisions.

INTRODUCTION

The Government needs taxes to fund its many activities and social responsibilities. In 1990/91 the tax system will collect an estimated $27 billion, or 37% of GDP.

The challenge is to collect this large sum fairly and without jeopardising the economy's chances of high growth and employment. Any tax system that takes a substantial share of the country's income has unavoidably strong effects on economic performance. While overseas studies vary widely, many estimates of the total cost to an economy of raising an additional dollar of tax revenue are in the range $1.20 to $1.60. The current level of Government expenditure is justified only if the benefit to the economy of the last dollar of Government expenditure exceeds this cost.

The cost to the economy of raising taxes arises through the tax system's adverse impact on the myriad of decisions on which growth ultimately depends: the investment decisions of businesses, and the work and savings decisions of individuals. In collecting revenue, the tax system should interfere as little as possible with these decisions. In particular, it should neither favour some at the expense of others, nor impose undue compliance costs. It should thereby facilitate investment in activities with the greatest underlying productivity, rather than those that look artificially attractive because of tax breaks.

MAKING THE TAX SYSTEM WORK BETTER

The tax system requires the formation of policy, the translation of policy into rules, the administration of those rules, and the resolution of tax disputes. It involves the active participation of thousands of taxpayers, their agents and their advisers. The overall effectiveness of the tax system depends on the contribution and co-ordination of each of these elements.

Tax Legislation

The New Zealand tax system relies heavily on self assessment. Tax rules must therefore be communicated to a wide variety of taxpayers. The legal basis for all current income tax rules is the Income Tax Act 1976. That Act has grown rapidly in length and complexity. This is a product of the economy having become more open, tax planning having become more sophisticated, and law drafters having continued their attempts to anticipate and limit avoidance and abuse.

However, it is becoming increasingly difficult to anticipate all contingencies with detailed statutory rules. There is a very real danger that the general principles and concepts in particular regimes are getting lost in the mass of legislative detail. As a consequence, the Income Tax Act fails to achieve one of its main purposes: communicating clearly to taxpayers and their advisers. This has profound implications for the tax system. In a self-assessment system, taxpayers themselves decide whether a tax rule applies to them. For the most part, they do so without assistance and without audit.

One option to improve the power of the Act to communicate with taxpayers would be to simplify its provisions. The Valabh Committee is currently working on this. However, when market transactions and tax-planning strategies are often complex, there is a limit to the extent to which simplicity can be achieved.

A m ore realistic objective of tax law would be to communicate core tax concepts with clarity. This may involve leaving much of the detail to be provided in other ways, perhaps through regulations and advance rulings. If this approach is taken, the principle that there should be no taxation without the approval of Parliament must not be breached; the core principles in the tax statute should clearly be the source of the more detailed rules. While it is not yet clear that this approach is the preferred option, the issue needs further serious study. The aim is to reduce the compliance and administration costs incurred in understanding how tax law applies to a taxpayer's specific situation.

Compliance and Administration

Taxpayers also incur compliance costs in meeting the reporting and payment requirements of the law, and in resolving disputes with the Inland Revenue Department (IRD) about the amount of tax payable. There is a need to follow up and build on the work of the Tax Simplification Consultative Committee in reducing compliance and administration costs. In particular, taxpayers have been seeking a more effective system for resolving tax in dispute. Such a system may involve both improved administrative review procedures and a more rapid resolution of important cases.

In practice, simplification often reduces or delays revenue, increases IRD's administration costs, or reduces the comprehensiveness of the tax base. Since raising revenue from other sources also involves substantial costs, tradeoffs are required. For example, complex regimes like the accrual rules are sometimes necessary to preserve a broad-based and efficient tax system, even though they undoubtedly raise compliance costs for some taxpayers. However, it is still vital to give due weight to compliance costs. These costs are particularly burdensome on small businesses, and they reduce public acceptance of the tax system.

Revising the Tax System

Amendment of tax laws is an inherent part of any tax system. A poor process for considering and implementing reforms can result in defective reforms, and can also undermine the public acceptability on which the system depends. While the reform process is more open and effective than it used to be, there are a number of grounds for believing that remaining defects are impeding the quality of the reform process and its outcomes.

Concern about the tax-reform process has manifested itself in different ways. Some people have called for a pause in tax reform. Others have called for the establishment of another "repairs and maintenance" committee.

Behind the disquiet are concerns that reforms have been too rushed and the scope for consultation and public education has been too limited. The main reason for the speed of reforms was the desire to realise the gains from reform quickly. But in some respects it resulted from the need to generate the substantial revenue required to close the fiscal deficit. This appears to have undermined the acceptability of reform. Accordingly, future reform is likely to be easier if expenditure restraint limits the need to raise revenue.

To improve the acceptability of reform, we propose that:

- Advice from the private sector should be sought on priorities for tax reform. This would permit the Government to give due weight to public concerns before it decides which reforms to undertake, and would separate these decisions from the consideration by consultative committees of the way reforms should be implemented.

- The pace of reform should be slower. This would allow greater consultation at every stage of implementation, and would allow taxpayers time to assimilate reforms.

- The reasons for reform should be more widely publicised. Recent experience suggests that reforms which are widely understood, like GST, are better accepted than those, such as the international tax regime, which are not. While there are elements of the latter regime that may need review, some concerns are based on a misapprehension that the regime is solely an anti-avoidance measure and thus excessively onerous.

- Draft legislation should be published with a consultative document. As the experience with GST showed, this would provide an early check on the implementation and administration aspects of proposals, it could identify new issues to be considered, and it would provide greater certainty for taxpayers and their advisers about future law.

TAX DESIGN

A modern tax system is in some ways like a modern aircraft. Its effectiveness is critically dependent on careful, well-integrated design. A deficiency in one part can undermine other parts or indeed the whole system.

The Broad-base, Low-rate Approach

The present income and consumption tax bases are defined broadly, in the sense that taxable income and consumption comprise large proportions of total income and consumption, and that there are few explicit tax preferences.

The definition of taxable income has widened considerably in recent years. However, there is still significant scope for further broadening the income tax base. A broad-base approach is the best way to raise revenue fairly and at least cost:

- The broader the base, the lower the tax rates required to raise a given amount of revenue. Lower rates reduce the damaging effects of taxes on decisions to work, train, invest and save. Conversely, a tax concession of any form increases the tax rates required on other forms of income. One person's tax concession is another person's tax.

- Because broad tax bases include all forms of income and consumption, no sector of the economy gains an artificial competitive advantage at the expense of other sectors. Generally, investors' decisions will be in the best interests of New Zealand as a whole only if the investments offering the highest after-tax rates of return also offer the highest returns before New Zealand tax. Tax preferences cause economic losses because they draw resources from higher- to lower-productivity uses.

- Tax preferences can be unfair because they may benefit unintended groups of people - including in particular those with high income or wealth.

- Usually, it is difficult or impossible to define clear boundaries to fence-off the income or consumption to be given concessionary tax treatment. This results in complex legislation, high administrative and compliance costs, and falling revenue as taxpayers devise ways to characterise other income or consumption as belonging to the tax-preferred category.

- Granting explicit tax preferences to one sector normally leads to demands from others to be granted comparable benefits, since such preferences are normally justified by arguments which apply with similar force to other sectors. The outcome all too easily becomes a downward spiral of increasingly complicated and ineffective rules, revenue loss, and increasing tax rates on other income. This is inefficient and unfair.

Preferences which narrow the income tax base can take a number of forms, such as:

- partial or full exemption for certain sources or types of income

- immediate deductions for expenditure which should instead be capitalised because it provides future benefits

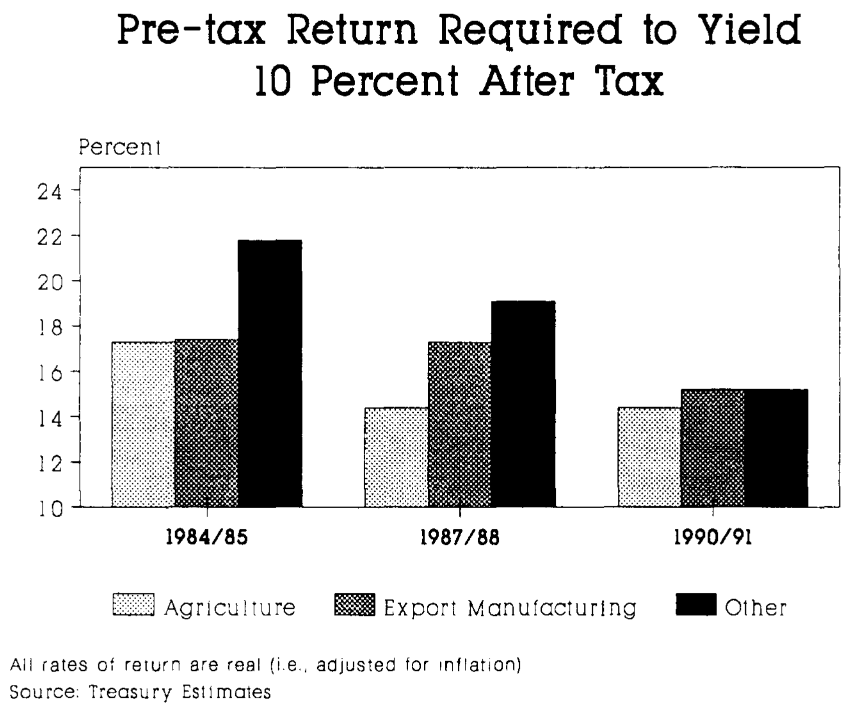
- more rapid depreciation for some capital assets than for similar assets employed in other sectors.

Taxing Different Industries

In the past, concessionary tax regimes unduly favoured investment in a number of sectors, including farming, forestry, bloodstock breeding, and mining. The concessionary regimes applying to these sectors (other than mineral mining) have all been reformed in recent years.

One method widely used internationally for assessing the effect of different tax rules across sectors is to measure the pre-tax rates of return required to generate an after-tax return of, say, 10% in each sector. Under a neutral tax system, these pre-tax returns would be equal. Figure 11.1 illustrates the effects of the tax rules in place in 1984, 1987, and 1990 on the required rates of return to investments in the agricultural, export manufacturing, and "other" sectors of the economy.

Figure 11.1



This shows that the reform process over the last few years has tended to reduce differences in the effects of tax rules applying to the different sectors. For example, investment in the "other" sector used to require on average more than a 4% higher pre-tax rate of return to compete with investment in agriculture. This difference is now under 1%.

The Influence of the World Economy on Tax Design

Financial-market deregulation and the dismantling of foreign-exchange controls in many countries have increased the international mobility of capital. For example, annual international capital flows are now around 40 times higher than the value of international trade flows. This has magnified the importance of the international boundary of the tax system. Poor design of this boundary runs serious risks of:

- higher interest rates than necessary
- loss of investment and jobs
- major loss of tax revenue.

Inward Investment

Imposing tax on the New Zealand income of foreigners can substantially raise the price New Zealand must pay to attract capital from overseas, raising the pre-tax returns investors will require on domestic capital, and reducing investment in New Zealand. A simple example illustrates this.

Suppose non-residents are able to obtain a return on investments outside New Zealand of 9% after source-country tax. To invest here, those investors would want a similar return on investments in New Zealand. If New Zealand imposes a 25% tax on the investment income of non-residents, pre-tax returns in New Zealand would have to rise to 12%, so that these investors receive the same after-tax rate as elsewhere.

However, this adverse effect need not always occur. Taxes on non-residents will not raise costs of capital if foreign governments allow their residents to claim credits for taxes paid in New Zealand. In this situation, lower tax rates on the New Zealand income of non-residents would needlessly sacrifice revenue without reducing the cost of capital.

More generally, the international boundary of the income tax system provides opportunities for exploitation. New Zealand cannot collect the revenue due on income earned in New Zealand if taxpayers are able to understate that income, and correspondingly overstate income sourced in lower-tax countries by, for example, transfer pricing. Consultative committees have called for the strengthening of provisions limiting such behaviour.

In short, taxes affecting cross-border transactions can have powerful effects, and need to be carefully designed. Parts of the tax system that need to be considered include aspects of company taxes, non-resident withholding taxes, double-taxation agreements, and the treatment of foreign income of New Zealanders.

Outward Investment

If New Zealand residents were not subject to tax on foreign income, overseas investment would be tax favoured. Residents' capital would flow overseas. This would increase New Zealand's need to rely on foreign loans and equity to finance investment in New Zealand and would lose tax revenue. To the extent that the foreign inflows were restricted, domestic costs of capital would rise with unfavourable effects on investment, jobs, and economic growth.

In addition, resident taxpayers would have an incentive to re-characterise domestic as offshore income by channelling it through companies in lower-tax countries. One study estimated that public companies alone in Australia made A$1.2 billion in tax-haven profits in 1987/88. Had this been taxed, the tax would have amounted to around 7% of total Australian corporate income tax.

As in other countries, New Zealand's recently instituted rules for taxing income from offshore investments are among the most complex provisions of the income tax system. Although improvements may be possible, some complexity seems inevitable. It results from the effort to protect the tax base without preventing New Zealanders from investing in profitable overseas assets. These rules represent one alternative to the unpalatable extremes of exempting foreign-source income entirely, or limiting capital exports by re-imposing foreign exchange controls.

Integration of Regimes for Inward and Outward Investment

Practical limitations on the taxation of outward investment are likely to impose constraints on the design of the regime for taxing inward investment, and vice versa.

Some of these constraints may be relieved by double-tax agreements (DTAs), since these can be used to co-ordinate the tax systems of pairs of countries in mutually supportive ways. In addition, DTAs can contribute importantly to the appropriate taxation of inward investment by providing that foreign governments allow investors in New Zealand to claim tax credits in exchange for reduced rates of New Zealand taxation. This can enable New Zealand to collect some tax from non-residents without increasing the domestic costs of capital.

On the other hand, treaties generally involve a sacrifice of some of the New Zealand tax base. If they are poorly negotiated, revenue losses and other costs could outweigh any benefits to New Zealand. In addition, defective DTAs can produce considerable unintended erosion of the domestic tax base by providing a conduit for "treaty shopping" taxpayers to transfer New Zealand income offshore.

Taxing Different Forms of Income from Capital

The current Income Tax Act does not clearly define the term "income". In general, New Zealand courts (in contrast to those in the United States) have held that income on revenue account is taxable, whereas income on capital account[1], commonly referred to as "capital gains", is not. However, these types of income are often close substitutes and their current tax treatment encourages taxpayers to shift their investment into activities that generate non-taxable income. This distorts investment patterns, thereby reducing growth and eroding the tax base. The solution to this problem is to give closely substitutable investments the same treatment. We discuss four options for reform:

- The current uncertain boundary between assessable and non-assessable income could be clarified without attempting to significantly narrow or broaden the base. This approach, however, would not solve the problems with the current treatment. There is also a risk that clarifying the current boundary without significantly altering it may make it easier for currently taxable forms of income from capital to escape the tax net.

- Another option would be to contract the current boundary to ensure that those forms of income most closely substitutable with capital gains are also exempt from tax. The difficulty with this approach is that, short of the removal of all such income from the tax base, there is no obvious point to stop. Removing all such income would result in the tax system being turned, in effect, into a tax on labour income only. Such a tax (if it could be made operational) would have much the same effects on behaviour as a consumption tax, in that it would exempt income from capital.

1 The difference between income on capital account and income on revenue account is a distinction drawn by the courts which, as the courts have said "is sometimes difficult to draw and leads to distinctions of some subtlety between profits that are made 'out of' assets and profit that is made 'upon' assets or 'with' assets" (CT v Nchanga Consolidated Copper Mines Ltd. [1964] AC 948 at page 960). A fuller explanation is contained in the Consultative Document on the Taxation of Income from Capital, page 20 ff.

- A third option would be to adopt the approach taken in most OECD countries and extend the income-tax base to include nearly all forms of income in the form of capital gains. The details of such an approach were set out in a consultative document released in December 1989. In the USA, the capital gains tax raised 8.9% of total income tax in 1988. In Australia it is forecast to raise 1.1% of total income tax in 1990/91, a figure which is growing annually by around 0.3% of income tax as transitional measures phase out. By way of comparison, 8.9% of income tax collected in New Zealand is about $1.5 billion and 1.1% is about $200 million.

- Last, the tax base could be extended somewhat to include just those forms of income that are closely substitutable for some forms of currently taxable income, such as gains from the sale of shares and commercial property, while leaving all less substitutable forms out of the base.

The Impact of Tax on Savings

Income taxes are often criticised because they discourage savings and productive investment. This occurs because an income tax imposes tax on income from capital (i.e., the return to savings and investment) at the same rate as on any other income. This may discourage investment or saving to varying degrees. Selective or generalised incentives for savings or for investment are sometimes advocated to overcome this. As discussed below, these may or may not be effective. In either case, such incentives are likely to require increased taxes on labour income to make up for lost revenue.

Selective Tax Concessions for Savings

Selective tax concessions have a number of undesirable effects. They require regulations to specify which institutions or schemes are to qualify for the concessions. These create incentives for institutions or schemes to alter their operations to fit within that definition, and individuals are encouraged to shift their savings away from the form that best suits their needs into tax-preferred alternatives. This process gives rise to considerable administration and compliance costs.

While selective concessions can have a marked impact in channelling existing savings into the tax-favoured form, evidence from overseas is unclear on the extent to which they actually increase aggregate private savings. They do, however, reduce tax revenue and thereby the level of Government savings. Unless the revenue loss is offset by tax increases or expenditure cuts, the level of aggregate national savings, which depends on the combined effects on private and Government savings, is likely to fall.

Selective savings incentives are sometimes advocated in order to provide improved standards of living for retired people and to reduce the burden of supporting the elderly through the benefit system. In the past, however, such concessions have been neither widely taken up nor well targeted.

In short, tax concessions for savings are undesirable for much the same reasons that concessions for income for particular sectoral uses of capital are undesirable. These reasons were described earlier in this chapter.

Generalised Measures Favouring Savings

There are, however, ways of reducing taxes on income from capital which have the attractive feature of reducing (rather than increasing) artificial discrimination between different forms of income from capital.

One way is to adjust the capital income base for the effects of inflation. One possible approach is outlined in detail in the Consultative Document on the Taxation of Income from Capital released last year. This document illustrated how rates of inflation as low as 2% can substantially increase the effective rate of tax on real income from capital imposed by our income tax system. Moreover, the impact is uneven; there is discrimination against some forms of investment relative to others. At higher rates of inflation, effective rates of tax can easily exceed 100%, imposing severe economic distortions and creating pressure for ad-hoc solutions.

Indexing the tax base would overcome these problems. However, indexation has the potential to increase compliance costs substantially, particularly for small businesses. Accordingly, these costs would need to be weighed up against the benefits of introducing full indexation.

Another way to reduce tax on saving without discriminating between forms of saving or investment is by placing heavier reliance on generalised consumption taxes levied indirectly (like GST) or directly on individuals. In contrast to income tax, a tax levied on consumption effectively exempts all capital income. There are a number of reasons why increasing reliance on consumption taxes may be desirable.

Tax and Social Policy

The tax system influences the distribution of income through the amount of tax which people pay, net of Government benefits which they receive, at different levels of income. This role is closely connected to the provision of income-tested benefits through the social-welfare system, which is discussed in Chapter 8.

It is desirable that the resources of the tax system and the social-welfare system are harnessed to exploit their complementarity. This is necessary to achieve efficient delivery of benefits and collection of taxes, and to minimise fraud.

CONCLUSION

The tax system is a large and complex structure, transferring a large share of the country's income to the state. It therefore has a major impact on the economic behaviour of all taxpayers. It touches nearly every business transaction in the economy and it can significantly affect international movements of goods and capital. Overseas estimates suggest that the efficiency, compliance, and administration costs imposed on an economy from raising additional revenue are substantial.

The tax system should minimise these costs. This requires that all the major components of the tax system - including the making of policy and the way it is put into effect, the interpretation and administration of tax law, and the resolution of disputes - should be designed to operate effectively and support each other. There are opportunities to make significant improvements in this area.

The taxation of different industries, international income flows, different forms of capital income, and the returns to savings made in different forms, all have important implications for revenue and for incentives to work, save and invest. Tax preferences should generally be avoided because they draw resources from higher to lower value uses. They also open the door for progressive erosion of the tax base thereby requiring increases in tax rates. Tax should be collected from non-residents in ways that enhance our growth prospects. The income tax base should be maintained and broadened to reduce tax rates and to ensure that investments offering the highest return before New Zealand tax also offer the highest after-tax return.

This broad-base approach is the best way to limit the costs associated with high marginal tax rates while maintaining fiscal responsibility. Combined with reductions in tax rates when that is feasible, this approach will contribute most to employment and growth.